Supreme Court, U.S.
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No.

In The

Supreme Court of the United States

October Term, 1997

ELIZABETH R. COCKRELL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

The issue to be decided is whether and in what circumstances a fair reading of Section 6013(e)(1)(C) of the Internal Revenue Code imposes an implied duty of inquiry for a non-culpable person to qualify as an innocent spouse; and, if under any circumstances the duty is imposed, whether such duty exists under circumstances where such inquiry would be unreasonable or futile.

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Jay J. Freireich, Esq., on behalf of Petitioner, Elizabeth R. Cockrell, ("Petitioner") petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit ("Second Circuit") in this case.

OPINIONS BELOW

The unpublished Summary Order of the Second Circuit is *Cockrell v. Commissioner of Internal Revenue*, Order #96-4072 (2nd Cir. June 24, 1997). The opinion of the Tax Court in *Crowley v. Commissioner*, is reported at T.C. Memo. 1993-503, ¶ 19,503 (RIA) (1993) ("*Crowley I*") and the Tax Court's Supplemental Memorandum Opinion in the same case is reported at T.C. Memo 1995-551, ¶ 95,551 (RIA) (1995) ("*Crowley II*").

STATEMENT OF JURISDICTION

The judgment of the Second Circuit was entered on June 24, 1997. On September 2, 1997, Justice Ginsburg extended time within which to file a petition for a writ of certiorari to and including November 21, 1997.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

1. Section 6013(d)(3) of the Internal Revenue Code, 26 U.S.C. § 6013(d)(3)[1] provides:

(d) Special rules

(3) [I]f a joint return is made, the tax shall be

1. All section references are to the Internal Revenue Code of 1986 as amended unless otherwise indicated.

computed on the aggregate income and the liability with respect to the tax shall be joint and several.

2. Section 6013(e)(1) provides:

> **(e) Spouses relieved of liability in certain cases.**
>
> **(1) In general**. Under regulations prescribed by the Secretary, if —
>
> (A) a joint return has been made under this section for a taxable year,
>
> (B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,
>
> (C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and
>
> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement.
>
> then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

3. Section 6013(e)(2) provides:

> **(2) Grossly erroneous Items.** For the purposes of this subsection, the term "grossly erroneous items" means, with respect to any spouse —
>
> (A) any item of gross income attributable to such spouse which is omitted from gross income, and
>
> (B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

4. Section 6013(e)(3) provides:

> **(3) Substantial Understatement.** For purposes of this subsection, the term "substantial understatement" means any understatement (as defined in section 6662(d)(2)(A)) which exceeds $500.

5. Section 6662(d)(1)(A) provides:

> **(1) Substantial understatement.**
>
> (A) In general. For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of —
>
> (i) 10% of the tax required to be shown on the return for the taxable year, or
>
> (ii) $5,000.

STATEMENT OF THE CASE

Federal Jurisdiction was vested in the United States Tax Court since this matter is a suit against Respondent for Federal taxes.

Section 6013(e)(1) permits a spouse filing a joint return to be relieved of joint and several liability in certain limited situations. This provision is an exception to the general rule of § 6013(d)(3), which renders each spouse jointly and severally liable for all items reported on their return.

Specifically, the instant case involves the proper construction of § 6013(e)(1)(C). Pursuant to this section, an individual seeking "innocent spouse" relief must not know or have reason to know of grossly erroneous items attributable to the other spouse, the existence of which results in a substantial understatement of tax liability. While no "duty of inquiry" is contained in the statute, courts have imposed a "duty of inquiry" on a spouse before she can meet the "should have known" standard. Petitioner asserts that either: (1) no duty of inquiry should be read into the statute; (2) that the duty of inquiry is only imposed in limited circumstances (not present in the case at bar); or (3) that the duty of inquiry is satisfied under such circumstances as such inquiry would be unreasonable or futile.

The following is a recitation of the relevant facts in this matter. On December 14, 1979, Petitioner and John P. Crowley were married. At that time, Petitioner was a Canadian citizen and Crowley was a United States citizen. Prior to her marriage to Crowley, Petitioner attended the University of Guelph, in Canada, where she received a Bachelor of Arts degree in English. In December 1980, Petitioner was hired as a stockbroker trainee and subsequently passed the "Series Seven" stockbroker examination in the early part of 1981, but had no training or

experience with commodities or straddles. During the time period prior to, and including the years 1980 and 1981 ("the years at issue"), Crowley was a well-known figure in the world of personal financial planning, whose advice regarding tax shelters was frequently sought by highly regarded financial publications.[2]

Crowley was a tax shelter investment promoter who actively marketed and sold investments in commodity straddle transactions involving treasury bill options.[3] These tax shelters were known as Arbitrage Management Tax Sheltered Investments ("Arbitrage"). Crowley was investing in Arbitrage prior to the marriage.

Crowley and Petitioner filed joint income tax returns for the years at issue claiming loss deductions as well as gains stemming from Crowley's premarital investment in Arbitrage.

On June 15, 1981, Petitioner and Crowley signed a joint return for the taxable year 1980, which reported an adjusted gross income of $8,055. This amount was basically comprised of Petitioner's wages of $3,373, Crowley's wages of $7,615 and substantially offsetting gains of $408,097 versus losses of

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2. Crowley was interviewed in Money Magazine and on the television program "Wall Street Week." (Tr. 51).

3. The transactions were in put options, which are options to sell a treasury bill at a particular price, on or before a particular date. The transactions in put options were structured to establish positions known as vertical put spread. A spread is a hedged position comprised of two substantially offsetting options. With a given change in the price of the underlying security, one option will appreciate in value while the other option will depreciate in value. The spread is ordinarily composed of one "long leg" — a purchased option — and one "short leg" — a sold (or granted) option.

$407,884. Most of the gains reported in 1980 were comprised of the gain leg from the 1979 Arbitrage straddle while most of the losses reported in 1980 were comprised of the loss leg from the 1980 Arbitrage straddle. Since the losses and gains substantially offset each other, there was nothing in the 1980 return to put anyone on notice that anything was amiss with the 1980 return.

On January 26, 1983, Petitioner and Crowley signed a joint return for taxable year 1981, and reported an adjusted gross income of $90,658. This amount was basically comprised of Petitioner's wages of $14,190, Crowley's wages of $39,134 and substantially offsetting gains of $697,896 versus losses of $670,327. Most of the gains reported in 1981 were comprised of the gain leg from the 1980 Arbitrage straddle while most of the losses reported in 1981 were comprised of the loss leg from the 1981 Arbitrage straddle. Since the losses and gains substantially offset each other, there was nothing in the 1981 return to put anyone on notice that anything was amiss with the 1981 return.

The loss deductions stemming from Arbitrage were subsequently disallowed by the Internal Revenue Service ("IRS") in a notice of deficiency sent by the IRS to Petitioner and Crowley. All the deductions at issue stem from Crowley's investment in Arbitrage and were promoted by Crowley's firm. Petitioner was not involved in Crowley's Arbitrage investment which began prior to the marriage and never dealt with commodities. She merely assisted in entertaining prospective investors attending seminars organized by Crowley.

Petitioner and Crowley entered into a standard settlement agreement offered by the IRS to all taxpayers involved in Arbitrage which only allowed for a 20% deduction of losses attributable to the commodities straddles for the years at issue.

The agreement left open the issue of whether Petitioner qualified as an "innocent spouse".

No children were born of Petitioner's marriage to Crowley. Petitioner had no involvement in the couple's business and financial affairs. The couple did not live lavishly during their brief marriage. In 1982, Petitioner and Crowley were separated and on August 18, 1983 they were divorced. Petitioner received no assets of any real value in the divorce.

Petitioner claimed to be an innocent spouse pursuant to § 6013(e)(1) for the years at issue in her Petition to the Tax Court. During the Tax Court trial, the attorneys for the Commissioner in the underlying Tax Court case failed to advise the court, or Petitioner's attorney, of critical facts known to them. To wit, the attorneys who were representing the Commissioner against Petitioner in the Tax Court were the very same attorneys who obtained convictions of the promoters of the Arbitrage shelter which gave rise to the substantial understatements in the case at bar. These convictions were not communicated to Petitioner's counsel and were not disclosed to the Tax Court. The existence of the convictions would have been a major factor in Petitioner's case on the issue of whether the tax shelter was grossly erroneous. However, the Tax Court in *Crowley I* held that Petitioner did not qualify as an innocent spouse finding that Petitioner did not offer sufficient evidence to support a finding that the losses were not "grossly erroneous" as defined in § 6013(e)(2)[4] and therefore, Petitioner did not satisfy

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4. A deduction is "grossly erroneous" when it has no basis in fact or law.

> A deduction has no basis in fact when the expense for which the deduction is claimed was never, in fact, made. A deduction has no basis in law when the expense, even if incurred, does

(Cont'd)

§ 6013(e)(1)(B). The court reached this conclusion on the strength of the testimony of Crowley and his associate that the Arbitrage straddles were profit-oriented[5]. Of course, at that time, neither the Tax Court nor Petitioner were aware of the convictions of the shelter promoters.

Following the decision of the Tax Court in *Crowley I*, Petitioner filed a motion for reconsideration pursuant to Tax Court Rule 161, asserting that: (1) newly available evidence established that the losses at issues were "grossly erroneous items" within the meaning of § 6013(e)(2); and (2) that the IRS's conduct in the Tax Court proceeding violated Tax Court Rule 201 and Rule 3.3(a)(5) of the Model Rules of Professional Conduct.

The evidence presented on reconsideration was that during the trial of the instant case, Respondent's counsel, William Blagg, Esq. failed to apprise the court that a partner in Arbitrage, Bernard F. Manko, and Manko's associate, John Edelman, were convicted on February 4, 1991 on multiple counts of Federal income tax fraud in violation of Code Sections 7206(1) and (2) and were also convicted of conspiring to defraud the United

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(Cont'd)

not qualify as a deductible expense under well-settled legal principles or when no legal argument can be made to support its deductibility.

Bouskos v. Commissioner, T.C. Memo. 1987-574 ¶87,574(P-H) (1987); citing Supplemental Report of Comm. On Ways and Means, H. Rept. 98-432 (Part 2), on H.R. 4170 (Tax Reform Act of 1984).

5. In its first published ruling, *Crowley I*, the Tax Court incorrectly ruled that the deductions taken were not grossly erroneous. Upon reconsideration, the Tax Court withdrew its prior ruling and instead ruled on the knowledge aspect without addressing whether or not the deductions were grossly erroneous. *Crowley II*.

States in violation of 18 U.S.C. § 371. They were each sentenced on November 25, 1991 to five years imprisonment and fined $450,000. These convictions were related to the Arbitrage investments marketed and sold after 1981.

Nevertheless, the Court in *Crowley II* concluded that due to the size of the deductions for the years at issue, Petitioner had a "duty to investigate" the deductions. *Crowley II* wrongly concluded that in light of Petitioner's education and career background, she should have known that the loss deductions were erroneous. Accordingly, Petitioner was denied "innocent spouse" relief in this matter. The Tax Court determined the following:

> (A) A deficiency in income tax in the amount of $45,653 and increased interest with respect to the amount of $22,826 under §6621(c) due from Petitioner and Crowley, for the calendar year 1980 in Tax Court Docket No. 28826-84; and
>
> (B) A deficiency in income tax in the amount of $53,911 and addition to the tax under §6651(a) in the amount of $15,123 and increased interest with respect to the amount of $26,500 under §6621(c) due from Petitioner for the calendar year 1981 in Tax Court Docket No. 7746-87.

The Second Circuit in *Cockrell v. Commissioner*, Order #96-4072 (2d Cir. June 24, 1997) affirmed the Tax Court decisions. The Second Circuit ruled that Petitioner had constructive knowledge of the loss deductions. The court concluded that given Petitioner's educational background and work experience she knew or should have learned "through investigation," that the joint returns contained substantial understatements. Therefore, Petitioner was again denied relief as an "innocent spouse."

REASONS FOR GRANTING THE WRIT

The decision of the Second Circuit in the case at bar creates a direct conflict among the circuits concerning the proper construction of § 6013(e)(1)(C). The resolution of this issue is necessary to avoid unnecessary litigation and to bring the circuit courts into conformity. In the absence of a review by this Court, a conflict among the circuits will continue unabated and subject many taxpayers eligible for innocent spouse relief to great hardship. In the absence of a review by this Court, Petitioner, a classic innocent spouse will be required to pay for the misdeeds of her miscreant husband from whom she has been divorced from for over 14 years after a short-lived marriage.

Second, the actions of the IRS in prosecuting the instant case, reveals systematic abuses in the administration of United States revenue laws. This Petition for Writ of Certiorari provides this Court with the opportunity to reaffirm and clarify the rights of taxpayers to be free of such abuse.

I.

THE SECOND CIRCUIT HAS RENDERED A DECISION THAT IS ERRONEOUS AND IN CONFLICT WITH THE DECISIONS OF OTHER CIRCUITS.

A. The Fifth Circuit Correctly Interpreted § 6013(e)(1)(C) In Refusing To Impose A Duty Of Inquiry Where Same Would Be Unreasonable Or Futile.

A recent decision of the Fifth Circuit in *Reser v. Commissioner*, 112 F.3d 1258 (5th Cir. 1997) involved the proper construction of § 6013(e)(1)(C). In *Reser*, 112 F.3d at 1269, the Fifth Circuit reversed a decision by the Tax Court which had denied Mrs. Reser, a licensed attorney, "innocent spouse" status.

The *Reser* court contemplated whether § 6013(e)(1)(C) required an innocent spouse to investigate items attributable to the other spouse where such inquiry would prove futile. In finding in favor of the wife on this issue, the court expressly rejected a construction of § 6013(e)(1)(C) that would create a "duty of inquiry" for Mrs. Reser by holding:

> . . . even if [Mrs.] Reser had conducted further inquiry, she would have gotten responses that corresponded exactly to the information as reported on the 1987 joint report. The Resers' 1987 joint return was prepared by [a] CPA, who concluded that the Resers were entitled to deduct the [shelter] losses. [Mr. Reser] testified at trial that when he filed the 1987 and 1988 joint returns, he believed that he had treated [the shelter] losses correctly in claiming them as deductions. . . .
>
> Had Reser asked [her husband, their accountant or the shelter's accountant] about the deductions, they would have told her what they believed — that [the shelter] losses were properly deductible in full. *Neither the court nor the law will penalize Reser for failing to perform the hollow act of asking questions, the answers to which would have provided no new or different information.*

(Emphasis added).

Thus, the *Reser* court held that there is no duty of inquiry, even to a licensed attorney, where such inquiry would have proved fruitless. In the case at bar, Petitioner, an English major with no experience in sophisticated business dealings, would have uncovered nothing had she asked Crowley, the promoter of the shelter, about the shelter's legitimacy. Burdening

Petitioner with a duty of inquiry would be improper as any inquiries by Petitioner would have proven pointless. Crowley was an active shelter promoter and undoubtedly would have advised Petitioner that the shelter was legitimate. The Second Circuit's finding of a duty of inquiry in Petitioner's circumstances has placed the Second Circuit in direct conflict with the Fifth Circuit. Such a dispute should be resolved by this Court.

B. The Seventh, Eighth, Ninth And Eleventh Circuits Have Correctly Determined That The Duty Of Inquiry Is Only Imposed In Very Limited Circumstances.

The Second Circuit is also in direct conflict with the Seventh, Eighth, Ninth and Eleventh Circuits regarding the duty of inquiry issue.

The Eighth Circuit in *Erdahl v. Commissioner*, 930 F.2d 585, 589 (8th Cir. 1991) established the test to determine whether the knowledge element of § 6013(e)(1)(C) is satisfied in cases involving disallowed deductions. The Eighth Circuit's test, which was adopted from *Price v. Commissioner*, 887 F.2d 959 (9th Cir. 1989) asks whether a reasonably prudent taxpayer would have known that a deduction would give rise to a substantial understatement in the taxpayer's returns.[6] Significantly, the interpretation of the "did not know, or had no reason to know" language by *Erdahl*, 930 F.2d at 589, and *Price*, only imposes a

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6. The Second Circuit, in *Hayman v. Commissioner*, 992 F.2d 1256 (2d Cir. 1993) has formulated a four-part test to determine if a spouse "had reason to know" pursuant to Section 6013(e)(1)(C). These factors are: (i) the spouse's level of education; (ii) the spouse's involvement in the family's business and financial affairs; (iii) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living and spending patterns; and (iv) the culpable spouse's evasiveness and deceit concerning their finances.

duty on the part of the innocent spouse to investigate reported items attributable to the culpable spouse in the very limited circumstances where she knew "enough facts to put her on notice that an understatement exists." *Price*, 887 F.2d at 590; *Pietromonaco v. Commissioner*, 3 F.3d 1342, 1345 (9th Cir. 1993).

The prerequisite notice for the imposition of a "duty of inquiry" exists only where "the spouse knows sufficient facts such that a reasonably prudent taxpayer in her position would be led to question the legitimacy of the deduction." *Price*, 887 F.2d at 965. Likewise, *Erdahl* only imposed a duty of inquiry where "a reasonably prudent taxpayer *in her position* [would] be led to question the legitimacy of the deduction." (Emphasis in text) *Id.*, 887 F.2d at 591; *Guth v. Commissioner*, 897 F.2d 441 (9th Cir. 1990).

Petitioner, in the case at bar, was not put on notice of such facts as would lead her, in *her* position and with her lack of experience and sophistication, to question the legitimacy of the deductions. Thus, the Second Circuit decision in the case at bar is in direct conflict with the Eighth and Ninth Circuits. The Eighth and Ninth Circuits would not require Petitioner to question the legitimacy of the deductions, since she was unaware of facts which would lead to the need to inquire further.

Furthermore, the Second Circuit decision in *Cockrell* is in direct conflict with the Seventh Circuit in *Resser*[7], 74 F.3d at 1536. The *Resser* Court recently ruled in favor of the spouse on the "should have known" test, stating that in determining whether a spouse "should have known" of a problem with an ostensible deduction,

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7. *Reser*, the Fifth Circuit case, should not be confused with *Resser*, the Seventh Circuit case.

> the court's analysis must focus on whether the spouse had sufficient knowledge of the facts underlying the claimed deductions such that a reasonably prudent person in the taxpayer's position would question seriously whether the deductions were phony.

Resser, 74 F.3d at 1536, citing *Stevens v. Commissioner*, 872 F.2d 1499, 1505 (11th Cir. 1989).

The Seventh Circuit is in conformity with and followed the Eighth and Ninth Circuits in only imposing a duty of inquiry only after it is established that a reasonably prudent wife would seriously question whether the deductions were phony. In the instant action, a reasonably prudent person in Petitioner's position would not have seriously questioned whether the deductions were phony. After all, Petitioner's husband was a highly-reputed shelter promoter who was often quoted in magazines and appeared on television in business news broadcasts, Furthermore, Petitioner did not possess any financial expertise that would impute knowledge to her about the subject shelters.

The Second Circuit decision in *Cockrell* is also in direct conflict with the Ninth Circuit in *Guth*, 897 F.2d at 444-45. *Guth* considered what circumstances create a duty of inquiry in the first instance. In *Guth*, the Ninth Circuit held that it is only when there is "something odd or unusual about the circumstances leading to the understatement that triggers the duty to inquire." Since nothing was odd about the subject deductions in the *Guth* case, the *Guth* court correctly concluded that no duty of inquiry arose.

Identical to the situation in *Guth*, in the case at bar, there was nothing apparently unusual about the subject deductions, nor was it odd that Petitioner lacked knowledge concerning the

tax ramifications of the Arbitrage investments. Petitioner's husband was a shelter promoter, and Petitioner had no expertise in the field.

Finally, the Second Circuit is in direct conflict with the Eleventh Circuit decision of *Kistner v. Commissioner*, 18 F.3d 1521, 1525-27 (11th Cir. 1994). The Eleventh Circuit ruled on when "further investigation is warranted" and determined it was only under limited circumstances. In *Kistner*, the wife lived extremely lavishly[8] and there were significant losses on the return. The court nevertheless held:

> at the time of signing the return, [Mrs. Kistner] could not be expected to know that the tax liability stated was erroneous, *or that further investigation was warranted.*

(Emphasis added). *Id.*, 18 F.3d at 1527.

In the case at bar, Petitioner was not on notice of any understatement and thus no duty of inquiry arose and no further investigation was warranted. A reasonably prudent person *in her position* would not have questioned the legitimacy of the deduction. Petitioner did not maintain a lavish lifestyle during her marriage to Crowley. Furthermore, the subject losses reported by Crowley were not so exaggerated as to put Petitioner on notice of any wrongdoing. Obviously, a prudent person in Petitioner's position would reasonably believe that the promoter of the tax shelter, who is quoted by major publications and on

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8. The wife had a $15,000/mo. allowance; there were purchases of two new Mercedes automobiles in 1979 and 1980; the couple vacationed in Europe; the couple attended horse races throughout the country; the couple employed a full-time maid and gardener; and the couple maintained two homes, one with a clubhouse, swimming pool and tennis court adjacent to it. *Id.*, 18 F.3d at 1525.

television, would not have taken illegitimate deductions. Petitioner was an English major from Canada who had never filed an American joint tax return when she was given the first return to sign. These circumstances militate against imposition of a duty of inquiry since Petitioner was not on notice that anything was awry with the returns.

Accordingly, the errant decision of the Second Circuit in the case at bar is in conflict with the decisions of the Seventh, Eighth, Ninth and Eleventh Circuits in its determination that a duty of inquiry arose in the Petitioner's circumstances at the time that the subject returns were signed.

C. The Second Circuit's Decision In This Case Is Incorrect.

The decision of the Second Circuit in this case is inconsistent with the well-established judicial interpretation of § 6013(e)(1)(C). The Second Circuit's holding would require Petitioner to have scrutinized her joint return, and determine that the subject deductions were not allowable. The Second Circuit erroneously declared that Petitioner was required to ask her husband about the legitimacy of the deductions.

The Second Circuit based its affirmance on Petitioner's failure to meet the standard for "duty of inquiry." The court was of the opinion that Petitioner "failed to ask her husband or anyone else about the legality of the deductions they claimed.[9]"

9. The 1981 return was not prepared by a CPA but rather by a person whom Petitioner believed to be a tax attorney. (Tr. 105). She discussed the commodities straddles at issue with Robert Kraft, Esq. (the alleged tax attorney). She was advised and she believed that a straddle was merely a tax deferral and not a tax avoidance technique. Although Petitioner was aware of the consequences of tax deferral (large tax liability in the final year), she was never advised that there was any question as to the validity of the resulting deductions. (Tr. 100-102). Given the complexity of the transactions and her unfamiliarity with Arbitrage, Petitioner reasonably relied on Mr. Kraft's opinion.

Cockrell, at 2. The Second Circuit determined that this failure constituted willful ignorance[10]. Yet, the court failed to recognize two points: (1) the duty of inquiry only arises when Petitioner is on notice of facts leading to the understatement; and (2) even if a duty of inquiry were to be imposed, her husband, being the promoter of the tax shelter in question, would undoubtedly have responded that the deductions were legitimate. Certainly, the promoter of the shelter would not have told his wife that the deductions taken were not proper. Crowley had testified in the Tax Court that the losses taken were legitimate. The Second Circuit thus neglected to understand, as the Fifth Circuit in *Reser* did, that

> neither the court nor the law will penalize [a taxpayer] for failing to perform the hollow act of asking questions, the answers to which would have provided no new or different information.

Reser, 112 F.3d at 1269.

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10. The Second Circuit's belief that an innocent spouse's failure to review a joint return, without more, meaning she "should have known," was rejected by the Seventh Circuit in *Resser v. Commissioner*, 74 F.3d 1528 (7th Cir. 1996). "The fact that she signed the return without reading it does not require the conclusion that she had reason to know. . ." *Resser*, 74 F.3d at 1539.

See also Epstein v. Commissioner, T.C. Memo 1996-239 (RIA) ¶96,239; finding innocent spouse relief where the husband sold tax shelters:

> In the era that encompassed the years 1976-1978, individuals far more financially sophisticated than Petitioner let themselves believe [that] tax shelters would bring them substantial wealth, at little or no cost to themselves. . .

We, therefore, hold that Petitioner had no reason to know that the returns for the relevant years contained substantial understatements of tax.

In summary, the holding of the Second Circuit in the present case directly conflicts with the recent decision of the Fifth Circuit in *Reser* under which certain circumstances obviate the duty of inquiry, *i.e.* futility of inquiry. The decisions in the two circuits were issued approximately one month apart yet are strikingly contradictory. Additionally, the holding of the Second Circuit in the instant matter directly conflicts with the decisions of the Seventh, Eighth, Ninth and Eleventh Circuits regarding the circumstances that trigger a duty of inquiry in the first place. The questions addressed in these cases have substantial importance in the administration of the Internal Revenue Code and may affect numerous taxpayers' liability for taxes rightfully attributable only to their spouses.

D. The Second Circuit's Decision Is Contrary To Legislative Intent — I.R.C. § 6013(e)(1).

It is clear that the legislative intent behind I.R.C. § 6013(e)(1) contradicts the Second Circuit's interpretation of said provision. "The innocent spouse provision was enacted by Congress to remedy grave injustices." *Bliss v. Commissioner*, 59 F.3d 374, 378 (2d Cir. 1995) quoting *Hayman v. Commissioner*, 992 F.2d 1256, 1259 (2d Cir. 1993). "In order to effectuate the stated legislative intent, § 6013(e)(1) should be construed and applied *liberally* in favor of the person claiming their benefits." (Emphasis added). *Friedman v. Commissioner*, 53 F.3d 523, 528-29 (2d Cir. 1995); *See also Bliss*, 59 F.3d at 378. Section 6013(e)(1) was enacted to

> correct unfair prior case law that held innocent spouses liable for the tax consequences of their partners' misdeeds, and "to bring government tax collection practices into accord with basic principles of equity and fairness."

Bliss, 59 F.3d at 380 (Oakes, J., dissenting); *See also* H.R. Rep. No. 1734, 91st Cong. 2d Sess. 2 (1970).

The Tax Court in the case at bar, *Crowley II* at n.18, indicated that there was such an injustice to Petitioner and it "sympathize[d] with [Petitioner's] plight" but nevertheless felt constrained to deny "innocent spouse" relief. The Second Circuit, in affirming the Tax Court's opinion, completely disregarded the remedial nature and intent of § 6013(e).[11] The Second Circuit's decision in *Cockrell*, rather than ameliorating the harsh consequences of joint and several liability, penalized Petitioner and similarly situated innocent spouses who will be bound by this unfortunate precedent, which is contrary to the Legislative intent.

E. The "Innocent Spouse" Provision Is In A State Of Flux And Needs Clarification.

Abuse by the IRS has recently come under fire stemming from Senate hearings uncovering horrific mistreatment of taxpayers by the IRS. The House of Representatives signed a Bill and presented it to the Senate for consideration (the "House Bill")[12] which calls for sweeping changes in the manner in which the IRS will be allowed to treat taxpayers. Furthermore, the House Bill will add checks and balances to the administration of the Internal Revenue Code.

Following many years of inconsistent rulings by the courts

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11. As explained by the Fifth Circuit: "Section 6013(e) is a remedial statute. Its sole purpose is to remedy, in certain circumstances, the inequities . . . of joint liability." *Allen v. Commissioner*, 514 F.2d 908, 915 (5th Cir. 1975)

12. H.R. 2292, to be known as the "Internal Revenue Service Restructuring and Reform Act of 1997."

in deciding cases construing the "innocent spouse" provisions, the House of Representatives sent the House Bill to the Senate and proposed to once again broaden the innocent spouse law which Congress initially enacted in 1971[13] and had subsequently broadened in 1984[14]. The House Bill broadens the categories of situations in which innocent spouse relief will be afforded by removing some of the hurdles contained in § 6013(e).

The House Bill calls for deleting § 6013(e) and adding a new section to the Internal Revenue Code as follows:

Section 6015. Innocent Spouse Relief; Petition to Tax Court.

(a) Spouse Relieved of Liability in Certain Cases. —

(1) In General. — Under procedures prescribed by the Secretary, if —

(A) a joint return has been made under Section 6013 for a taxable year,

(B) on such return there is an understatement of tax attributable to erroneous items of 1 spouse,

(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such understatement,

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13. Act of Jan. 12, 1971, Pub. L. No. 91-679, 84 Stat. 2063.

14. Section 424(c) of the Deficit Reduction Act of 1984 provides for retroactive application of the amendments permitting innocent spouse relief to disallowed deduction cases for all open years. H.R. Rep. No. 98-432, 98th Cong., 2d Sess., pt. 2, at 1503, *reprinted in* 1984 U.S. Code Cong. and Admin. News 697, 1144.

> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such understatement, and
>
> (E) the other spouse claims (in such form as the Secretary may prescribe) the benefits of this subsection not later than the date which is 2 years after the date of the assessment of such deficiency,
>
> then the other spouse shall be relieved of liability for tax (including interest, penalties and other amounts) for such taxable year to the extent such liability is attributable to such understatement.

The requirements found in the current law that the understatement of tax be "substantial" and that such understatement be "grossly erroneous" are conspicuously absent from the House Bill.

Although the changes currently being considered by Congress will affect taxpayers prospectively[15], there are many "innocent spouse" taxpayers affected by the current law. This Court's determination of this important issue for innocent spouses will also have prospective effect even if the House Bill is enacted, since the "knew or should have known" language at issue in the case at bar is still contained in the House Bill.

The questions for consideration in the case at bar and not amended by the House Bill is the construction of the phrase: "the spouse knew or should have known," whether and in what

15. The current version of the House Bill provides for that it is only effective for taxable years beginning after the date of the enactment of the Act. Section 321(e) of the House Bill.

circumstances there is an implicit "duty of inquiry" therein and under which circumstances it is obviated.

Even if there is a "duty of inquiry," the circuits have differed on whether to invoke a "duty of inquiry" where such inquiry would not have uncovered any errors. *See* Point I, *supra*.

The House Bill attempts to redress these inconsistencies in favor of the non-culpable taxpayer. The courts are left with the responsibility to construe the language of the existing law and to do so broadly. Unfortunately, the Second Circuit has taken an unduly restrictive reading of § 6013(e) in direct conflict with other circuits. Such a reading should not be allowed, and therefore, this Court should remediate the situation by granting *certiorari*.

II.

THE ABHORRENT IRS PRACTICES IN THE CASE AT BAR REQUIRE THAT THIS CASE BE REVIEWED.

Petitioner respectfully requests *certiorari* because this case presents this Court with the opportunity to provide much needed judicial review of the abhorrent practices of the IRS.

A review of the legality of IRS activities is especially timely in light of the recent testimony before the Senate Finance Committee. The hearings outlining the abuses of the IRS illustrated a fundamental distrust of the agency by a large segment of the United States Population. In this regard, Sen. William V. Roth, Jr., Chairman of the Senate Finance Committee, stated:

> The stories told by the taxpayers and agents at our hearing were not just anecdotes; they revealed a larger

> problem deeply rooted in the agency — a problem that will not yield to a quick fix. These hearings have hopefully been a wake up call for the IRS. The flood of phone calls, faxes and e-mails to my office in the past week shows that Americans are paying attention and expect results. Where appropriate, we will be taking legislative action. Statement Sen. William V. Roth, Jr., Chairman, Senate Finance Committee.
>
> Associated press, September 30, 1997 — Congressional Press Release.

It is well settled that the judiciary stands as a bulwark against governmental intrusion on civil liberties. The prosecutorial misconduct that the IRS employed during this case was not an isolated incident or an aberration. As the Senate testimony illustrates, taxpayers are often at the mercy of overzealous IRS employees who place their professional advancement above ethical and legal principles. The IRS conduct in the Tax Court violated well settled ethical norms and raises serious questions about the administration of United States revenue law. The IRS asserted in the Tax Court that the deductions taken by Crowley in 1980 and 1981 were not "grossly erroneous" as defined in § 6013(e), while at the same time prosecuting and procuring convictions of the shelter organizers of tax fraud in connection with Arbitrage. Were this Court not to review this egregious practice, it would tacitly countenance the practice at the expense of an innocent Petitioner whose rights and liberties were trampled.

In *Crowley I*, the Tax Court erroneously ruled that the deductions were not grossly erroneous. At that time, the Tax Court was unaware of the convictions of the shelter promoters (since the IRS failed to so apprise the Tax Court). However, the IRS attorneys representing the Commissioner in the Tax Court

were well aware of the convictions, as they were the prosecuting attorneys of Manko and Edelman. After Petitioner's counsel learned of the convictions through independent sources and brought Petitioner's Motion for Reconsideration to the Tax Court, the Tax Court merely withdrew its prior ruling. The Tax Court disallowed Petitioner relief by ruling against her on the knowledge issue without even addressing whether the deductions were grossly erroneous. *Crowley II*.

IRS Counsel deliberately failed to disclose highly probative evidence concerning the illegitimacy of the loss deductions. Bernard F. Manko, a partner of Crowley, and John Edelman, Manko's associate, were convicted on February 4, 1991 on multiple counts of federal income tax fraud in violation of § 7206(1) and (2) and also convicted of conspiring to defraud United States in violation of 18 U.S.C. § 371. The Second Circuit in *United States v. Manko*, 979 F.2d 900, 904 (2nd Cir. 1992) affirmed these convictions and described these transactions as involving "typing, not trading." The court stated that there was "powerful evidence that the purported transactions were shams that never took place." *Id*. The convictions of Manko and Edelman involved fraudulent and fictitious treasury bill transactions similar in nature to those involved in the instant case. The 1980 and 1981 transactions in the case at bar were part of the same tax shelter program as those involved in the convictions.

IRS Counsel in the instant action were the same counsel involved in the criminal prosecution of Manko and Edleman. However, IRS Counsel did not disclose the convictions to Petitioner or the court when cross examining Mr. Sinclair, a partner of Crowley at Arbitrage, regarding its operation. Respondent's counsel had a duty under the Tax Court Rule 201(a) and Model Rules of Professional Conduct of the American Bar Association to disclose this information. RPC.

3.3(a)(5) prohibits a lawyer from "knowingly fail[ing] to disclose to the tribunal a material fact with knowledge that the tribunal may tend to be misled by such failure." The fact that the shelter promoters were convicted in connection with the Arbitrage investment, albeit in a later year, was directly adverse to the Commissioner's position that the disallowed Arbitrage deductions were not grossly erroneous.

In the past few months, the topic of IRS abuses inflicted against taxpayers has been discussed almost daily in the media. The Senate hearings on these IRS abuses have taken center stage and have captivated this country. Following the litany of horror stories by taxpayers (and even IRS agents) that were told to the Senate, taxpayers have demanded widespread changes in the administration of Internal Revenue Code. President Clinton has issued a statement calling for changes. The House put forth the House Bill which calls for an Oversight Board composed primarily of persons from the private sector to oversee IRS practices. In the wake of this controversy, the IRS has convened to discuss how to avoid the widespread abuses that have led to the public furor.

While the legislative and executive branches have spoken on this topic, this case gives the judicial branch an apt opportunity to denounce IRS abuse of taxpayers.

In summary, Petitioner requests that this Court make clear that this type of unfair practice by the agency entrusted with the administration of United States revenue law is both unethical and violates all notions of due process.

III.

THE SUPREME COURT SHOULD CONSIDER THE "INNOCENT SPOUSE" ISSUE NOW, AS THE ISSUE IS RIPE.

It is now an opportune time for this Court to consider an innocent spouse tax case. Petitioner's case involves not only an occasion for this Court to determine the liberality with which the courts should construe innocent spouse laws, but it also involves an opportunity to review a case of IRS abuse committed against Petitioner. As such, it is the quintessential innocent spouse case for this Court to consider.

The unfair overzealousness by the IRS attorneys in attempting to defeat Petitioner at all costs is precisely the type of abuse that is so abhorrent in this country. By granting *certiorari* in this case, this Court would have the opportunity to castigate the unfair tactics committed by the IRS.

CONCLUSION

In the absence of the resolution of the conflict among the circuits, the tax consequences to spouses will vary based solely on geographical happenstance. Resolution of this important question is needed to avoid continuing uncertainty and to assure even-handed application of the revenue laws throughout the country. This petition for a Writ of Certiorari should therefore be granted.

Respectfully submitted,

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APPENDIX A — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT FILED JUNE 24, 1997

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

THIS SUMMARY ORDER WILL NOT BE PUBLISHED IN THE FEDERAL REPORTER AND MAY NOT BE CITED AS PRECEDENTIAL AUTHORITY TO THIS OR ANY OTHER COURT, BUT MAY BE CALLED TO THE ATTENTION OF THIS OR ANY OTHER COURT IN A SUBSEQUENT STAGE OF THIS CASE, IN A RELATED CASE, OR IN ANY CASE FOR PURPOSES OF COLLATERAL ESTOPPEL OR RES JUDICATA.

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 24th day of June, one thousand nine hundred and ninety-seven.

PRESENT:

HON. JOHN M. WALKER, JR.,
HON. GUIDO CALABRESI,
HON. DONALD P. LAY,
*Circuit Judges.**

ELIZABETH COCKRELL,

Petitioner-Appellant,

v.

The Honorable Donald P. Lay, Senior Judge of the United States Court of Appeals for the Eighth Circuit, sitting by designation.

Appendix A

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

ORDER
96-4072

Appearing for Appellant: Jay J. Freireich, Poe & Freireich, Florham Park, N.J.

Appearing for Appellee: Jonathan S. Cohen, Tax Division, Department of Justice, Washington, D.C.

UPON CONSIDERATION of this appeal from decisions of the United States Tax Court (Wells, *J.*), it is hereby

ORDERED, ADJUDGED, AND DECREED that the decisions be and they hereby are

AFFIRMED.

Elizabeth Cockrell appeals from decisions of the United States Tax Court (Thomas B. Wells, *Judge)* entered February 29, 1989 determining a deficiency in income taxes for Cockrell and her former husband, John P. Crowley, for the tax year 1980, and a deficiency for Cockrell for the tax year 1981. In its Memorandum Opinion, filed November 1, 1993, *see Crowley v. Commissioner*, 66 T.C.M. (CCH) 1180 (1993), and its Supplemental Memorandum Opinion, filed November 20, 1995, *see Crowley v. Commissioner,* 70 T.C.M. (CCH) 1374 (1995), the tax court rejected Cockrell's argument that she is entitled to relief from these deficiencies under I.R.C. § 6013(e), which

provides an exception to joint and several liability for those who can establish innocent spouse status.

Cockrell argues on appeal that the tax court erred in finding that she did not meet the requirements for relieving innocent spouses of liability. In particular, she contends that she has demonstrated (1) that the deductions that caused the understatement were "grossly erroneous items"; (2) that "she did not know, and had no reason to know, that there was [a] substantial understatement" in the joint returns she signed with her former husband; and (3) that it is inequitable to hold her liable for the deficiencies. *See* I.R.C. §§ 6013(e)(1)(B), 6013(e)(1)(C), 6013(e)(1)(D). In order to qualify for innocent spouse status, Cockrell must prove all of these elements. *See Hayman v. Commissioner,* 992 F.2d 1256, 1260 (2d Cir. 1993).

Although Cockrell claims to have signed the returns at issue without reading them, "she nevertheless is charged with constructive knowledge of their contents." *Id.* at 1262. Furthermore, "large deductions, such as tax shelter losses offsetting income from other sources and substantially reducing or eliminating the couple's tax liability, generally put a taxpayer on notice that the tax return may contain substantial understatements." *Friedman v. Commissioner,* 53 F.3d 523, 531 (2d Cir. 1995) (internal quotation marks omitted). The tax returns Cockrell signed included large deductions of this sort. In 1980, for example, a gain of $408,097 was offset by a loss of $407,884. The return reported adjusted gross income of only $8,055 and a tax due of $240. Yet, despite this indication that the tax returns might contain substantial understatements, Cockrell took no steps to fulfill even the most minimal "duty to enquire as to the propriety of" the tax shelter deductions. *Id.* She failed to ask her husband or anyone else about the legality of the deductions they claimed.

Appendix A

Cockrell was college-educated, had passed the "series seven" examination for stockbrokers, and worked as a stockbroker trainee. She was involved, albeit in a limited way, in her husband's business, since she attended seminars with him, attempted to attract clients for her husband, and entertained clients at home. Cockrell and Crowley lived lavishly during 1980 and 1981. And there is no evidence that Crowley was evasive or deceitful about their finances in general or about the commodities straddle transactions that served as the basis for the tax shelters in particular. All of these factors suggest that a prudent taxpayer in Cockrell's position could be expected to know or reasonably to be able to ascertain that the returns she signed may have contained substantial understatements. *See Hayman*, 992 F.2d at 1261 (citing *Price v. Commissioner*, 887 F.2d 959, 965 (9th Cir. 1989)).

Accordingly, we hold that there were ample grounds for the tax court to conclude that Cockrell had "reason to know" that the deductions would give rise to a substantial understatement and that its findings of fact are not clearly erroneous. Since Cockrell's failure to establish *any* element required by Section 6013(e) is a sufficient basis for denying her innocent spouse status, we need not address the other elements of the section.

We have examined all of Cockrell's contentions and found them to be without merit. The tax court's decisions are affirmed.

s/ John M. Walker, Jr.
Hon. John M. Walker, Jr.

s/ Guido Calabresi
Hon. Guido Calabresi

s/ Donald P. Lay
Hon. Donald P. Lay

Circuit Judges.

APPENDIX B — DECISION OF THE UNITED STATES TAX COURT ENTERED FEBRUARY 29, 1996

UNITED STATES TAX COURT

Docket No. 7746-87

ELIZABETH R. COCKRELL,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinions of the Court filed November 1. 1993 and November 20, 1995, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1981 in the amount of $53,911.00;

That there is an addition to tax due from the petitioner for the taxable year 1981, under the provisions of I.R.C. § 6651(a), in the amount of $15,123.00;

That there are no additions to tax due from the petitioner for the taxable year 1981, under the provisions of I.R.C. §§ 6653(a)(1) and 6653(a)(2); and

Appendix B

That for the taxable year 1981, $26,500.00 is a substantial underpayment attributable to tax-motivated transactions, for purposes of computing the interest payable with respect to such amount, pursuant to I.R.C. § 6621(c).

(Signed) Thomas B. Wells
Judge.

Entered: FEB 29 1996

* * * * *

The parties stipulate that the foregoing decision is in accordance with the opinions of the Court and the respondent's computation, and that the Court may enter this decision without prejudice to the right of either party to contest the correctness of the decision entered herein.

APPENDIX C — SUPPLEMENTAL MEMORANDUM OPINION OF THE UNITED STATES TAX COURT FILED NOVEMBER 20, 1995

T.C. Memo. 1995-551

UNITED STATES TAX COURT

JOHN P. CROWLEY AND ELIZABETH R. COCKRELL, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent*

Docket Nos. 28826-84, 7746-87. Filed November 20, 1995.

Stanley M. Klein, and *Michael J. Weitzner*, for petitioner John P. Crowley in docket No. 28826-84.

Alan J. Garfunkel, Marc S. Orlofsky, and *Edward Rubin*, for petitioner Elizabeth R. Cockrell in docket Nos. 28826-84 and 7746-87.

Drita Tonuzi and *Henry S. Schneiderman*, for respondent.

SUPPLEMENTAL MEMORANDUM OPINION

WELLS, *Judge*: These cases[1] are before us on petitioner Elizabeth R. Cockrell's[2] motion pursuant to Rule 161[3] for

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* This Supplemental Memorandum Opinion supplements our prior Memorandum Opinion in the instant case, *Crowley v. Commissioner*, T.C. Memo. 1993-503, filed November 1, 1993.

1. These cases (for convenience, hereinafter referred to as the instant case) have been consolidated for trial, briefing, and opinion.

2. As petitioner John P. Crowley has settled all issues in the instant case with respect to himself, hereinafter we will refer to Elizabeth R. Cockrell as "petitioner" and John P. Crowley as Mr. Crowley.

3. Unless otherwise indicated, all Rule references are to the Tax (Cont'd)

reconsideration of *Crowley v. Commissioner*, T.C. Memo 1993-503 (prior Opinion) In our prior Opinion, we held, inter alia, that petitioner was not entitled to relief under section 6013(e) as an innocent spouse from the understatements of tax for her taxable years 1980 and 1981 attributable to deductions claimed for losses incurred by Mr. Crowley in connection with certain commodities straddle transactions That holding was based on petitioner's failure to prove that such understatements of tax were attributable to "grossly erroneously items" pursuant to section 6013(e)(2)(B).[4]

Background

In her motion, as supplemented, petitioner requests, inter alia, that we reconsider our prior Opinion and either decide that she qualifies for relief as an innocent spouse based on the evidence already in the record or reopen the record to allow introduction of additional evidence in support of her claim that she qualifies for relief as an innocent spouse. Petitioner's requests are based on the following contentions: (1) That newly

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(Cont'd)
Court Rules of Practice and Procedure, and all section references are to the Internal Revenue Code in effect for the years in issue.

4. Because the requirements for relief as an innocent spouse under sec. 6013(e) are conjunctive, *Bokum v. Commissioner*, 94 T.C. 126, 138 (1990), affd. 992 F.2d 1132 (11th Cir. 1993), our holding that such deductions were not attributable to "grossly erroneous items" rendered it unnecessary for us to decide whether petitioner satisfied the other requirements of that subsection that were contested by petitioner and respondent (viz: (1) In signing the returns in issue petitioner did not know and had no reason to know of the existence of the understatements in issue and (2) it would be inequitable to hold petitioner liable for the deficiencies resulting from those understatements).

available evidence establishes that the deductions in issue are "grossly erroneous items" within the meaning of section 6013(e)(2); (2) that respondent's counsel at the trial of the instant case violated Rule 201 and rule 3.3(a)(3) of the Model Rules of Professional Conduct (Model Rules) in not disclosing certain information petitioner alleges is relevant to that question; and (3) that petitioner is entitled to relief as an innocent spouse pursuant to the transitional rule of section 6004 of the Technical and Miscellaneous Revenue Act of 1988 (TAMPA), Pub. L. 100-647, 102 Stat. 3685-3686 (transitional rule).[5]

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5. The transitional rule provides as follows:

Sec. 6004. TREATMENT OF CERTAIN INNOCENT SPOUSES

Subsection (c) of section 424 of the Tax Reform Act of 1984 (relating to innocent spouse relieved of liability in certain cases) is amended by adding at the end thereof the following new paragraph:

"(3) Transitional Rule. — If —

"(A) a joint return under section 6013 of the Internal Revenue Code of 1954 was filed before January 1, 1985,

"(B) on such return there is an understatement (as defined in section 6661(b)(2)(A) of such Code) which is attributable to disallowed deductions attributable to activities of one spouse,

"(C) the amount of such disallowed deductions exceeds the taxable income shown on such return,

"(D) without regard to any determination before October

(Cont'd)

Appendix C

Although we incorporate into this Opinion by reference the findings of fact in our prior Opinion, we restate below certain of those findings that are relevant to the issues presented by petitioner's motion for reconsideration, and we further set forth certain supplementary findings of fact that were not set forth in our prior Opinion but are, however, based on the record of the trial of the instant case and relevant to our analysis below.

On November 14, 1979, petitioner and Mr. Crowley were married. At that time, petitioner was a Canadian citizen and Mr. Crowley was a U.S. citizen. They were married in a New York civil ceremony. On November 17, 1979, petitioner and Mr. Crowley were married a second time in a Canadian church. Prior

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(Cont'd)

21, 1988, the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such an understatement, and

"(E) the marriage between such spouses terminated and immediately after such termination the net worth of the other spouse was less than $10,000,

notwithstanding any law or rule of law (including res judicata), the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such understatement, and, to the extent the liability so attributable has been collected from such other spouse, it shall be refunded or credited to such other spouse. No credit or refund shall be made under the preceding sentence unless claim therefor has been submitted to the Secretary of the Treasury or his delegate before the date 1 year after the date of the enactment of this paragraph, and no interest on such credit or refund shall be allowed for any period before such date of enactment". [Emphasis added.]

to her marriage to Mr. Crowley, petitioner attended the University of Guelph, in Canada, where she received a bachelor of arts degree. From August 1977 until August 1979, petitioner worked in Canada as a life insurance agent first for Prudential Assurance and then Montreal Life Insurance.

Shortly after the marriage ceremony in Canada, petitioner and Mr. Crowley returned to New York. During 1980, petitioner worked for a photographer in New York City for 1 week in exchange for learning about photography. For 2 weeks, she solicited, by telephone, on behalf of a messenger service located in New York City, for which she was compensated approximately $200.

During December 1980, petitioner was hired as a stockbroker trainee in New York. In order to prepare for the "series seven" stockbroker examination required for her employment, petitioner studied about stocks and bonds at home. Prior to passing the exam, petitioner answered the telephones for her employer. During the early part of 1981, petitioner passed the exam and obtained her stockbroker license. Subsequently, petitioner "cold-called" potential clients to sell them stocks and bonds. Neither petitioner's studies nor her work specifically included commodities tax straddles.

During the years in issue, Mr. Crowley was a partner in TSM Associates, Sinclair Securities Company, and APEX Associates, which were partnerships that had engaged in commodities straddle transactions involving Treasury bill options. Mr. Crowley, as an employee in James Sinclair Trading Corporation, arranged commodities straddle transactions for investors seeking "taxsheltered investments".

Appendix C

Petitioner was aware of Mr. Crowley's position as a "commodities trader". Petitioner accompanied Mr. Crowley at several commodities seminars during which she "milled about" at the back of the room, "drifted" in and out of the seminar rooms, and socialized with other wives attending the seminars. Petitioner attempted to attract clients for her husband at the hospitality suites provided by Mr. Crowley's employer after those seminars. Petitioner, however, did not discuss commodities straddle transactions during the seminars or in the hospitality suites.

When petitioner and Mr. Crowley were first married, they rented a one-bedroom apartment in Manhattan. During their marriage, petitioner and Mr. Crowley regularly entertained Mr. Crowley's clients at their apartment, and they frequently dined out at expensive restaurants in Manhattan. During 1980, Mr. Crowley and petitioner took vacations to Canada, Vermont, and Florida. Mr. Crowley's American Express bill for that year was approximately $90,000, and a substantial portion of that amount was charged by petitioner. During 1981, they moved to a two bedroom apartment which they rented for approximately $1,400 or $1,500 per month and garaged Mr. Crowley's BMW automobile for approximately $250 to $300 per month. Subsequently, they rented a ranch house on Long Island.

During 1982, petitioner and Mr. Crowley decided to separate. After their separation, petitioner moved into a small loft apartment and paid the security deposit with $2,000 which Mr. Crowley had given her. On August 18, 1983, petitioner and Mr. Crowley were divorced.

On June 15, 1980, petitioner and Mr. Crowley signed a joint tax return for taxable year 1979, which was filed on June 24,

1980, and reported a negative adjusted gross income in the amount of $71, 312. During 1979, Mr. Crowley earned $81,925 in commissions from the James Sinclair Trading Corporation. On June 15, 1981, petitioner and Mr. Crowley signed a joint tax return for taxable year 1980, which was filed before the end of the month, and reported an adjusted gross income of $8,055 and tax due of $240. During 1980, Mr. Crowley earned $122,683 in commissions from Sinclair Securities Company. On January 26, 1983, petitioner and Mr. Crowley signed a joint tax return for taxable year 1981, which was filed on January 31, 1983,[6] and reported an adjusted gross income of $90,658 and tax due of $13,980. During 1981, Mr. Crowley earned $148,141 in commissions from Sinclair Securities Company. Petitioner signed the joint returns for 1979, 1980, and 1981 without reviewing them.

The losses disallowed in the notices of deficiency were claimed by petitioner and Mr. Crowley on their 1979, 1980, and 1981 joint tax returns as Mr. Crowley's share of losses incurred by TSM Associates, Sinclair Securities Company, and APEX Associates. During the years 1979, 1980, and 1981, Mr. Crowley earned more than $380,000 in commissions.

Petitioner and Mr. Crowley entered into a settlement agreement with respondent that provides that petitioner and Mr. Crowley may deduct 20 percent of the losses attributable to the commodities straddle transactions for the years in issue, subject to petitioner's right to contest her liability for the taxes arising out of the settlement pursuant to section 6013(e). The settlement agreement contains standard settlement terms offered by

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6. Petitioner concedes that she is liable for the addition to tax for failure to file timely with respect to that return, unless she is relieved from such liability as an innocent spouse.

respondent to all taxpayers involved in the Arbitrage Management tax shelter litigation project.

Discussion

The decision to grant a motion for reconsideration rests within the discretion of the Court and such a motion will not be granted unless unusual circumstances or substantial error is shown. *Vaughn v. Commissioner*, 87 T.C. 164, 166-167 (1986). Moreover, it is our policy to try all of the issues raised in a case in one proceeding in order to avoid piecemeal and protracted litigation. *Alexander v. Commissioner*, 95 T.C. 467, 469 (1990).

Petitioner contends in her motion for reconsideration that we incorrectly held in our prior Opinion that the understatements in issue were not attributable to "grossly erroneous items". However, before deciding whether petitioner would be entitled to relief from liability as an innocent spouse if we were to accept that contention, we shall consider whether petitioner fails to satisfy any of the other requirements for innocent spouse relief under section 6013(e) that were contested,[7] tried, and briefed by the parties but were not addressed in our prior Opinion. The present record in the instant case is sufficient for us to decide the other undecided requirements for innocent spouse relief under section 6013(e).[8] For the reasons set forth below, we

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7. Respondent concedes that petitioner meets certain of the requirements for relief as an innocent spouse provided by sec. 6013(e).

8. Petitioner requests that we reopen the record to permit her to introduce, inter alia, her transcript from the University of Guelph to show that she took no courses in any tax, business, or financial subject, majored in English, and was "an extremely indifferent student". Petitioner contends that, after the trial of the instant case, the Count of Appeals for the Second

(Cont'd)

conclude that petitioner has failed to satisfy all of the requirements for relief as an innocent spouse provided by section 6013(e) and has failed to satisfy all of the transitional rule requirements as well. Accordingly, we need not reconsider the holding of our prior Opinion that the deductions claimed on the returns for the taxable years in issue are "grossly erroneous items" within the meaning of section 6013(e)(2)(B).[9]

(Cont'd)

Circuit announced a requirement for innocent spouse relief that a taxpayer's education be taken into account in deciding whether the taxpayer knew or had reason to know of the existence of a substantial understatement under sec. 6013(e)(1)(C). *Friedman v. Commissioner*, 53 F.3d 523, 531-532 (2d Cir. 1995), affg. in part, revg. in part, and remanding T.C. Memo. 1993-549; *Hayman v. Commissioner*, 992 F.2d 1256 (2d Cir. 1993), affg. T.C. Memo. 1992-228. Petitioner argues that the "new" requirement renders relevant petitioner's university transcript and the other evidence she seeks to admit and that such relevance could not have been anticipated at the time of such trial. Petitioner admits, however, that the requirement for innocent spouse relief adopted by the Second Circuit had been articulated by other courts prior to the trial of the instant case. See, e.g., *Price v. Commissioner*, 887 F.2d 959, 965 (9th Cir. 1989), revg. an Oral Opinion of this Court.

We do not agree with petitioner that she could not have been aware of the relevance of the evidence she now seeks to introduce simply because the Court of Appeals for the Second Circuit, at the time the instant case was tried, had yet to issue its opinions requiring that a taxpayers education level be taken into consideration. Moreover, petitioner contends that, even without such evidence, the record developed at the trial of the instant case is sufficient to support a finding that she did not know and had no reason to know of the existence of the substantial understatements in issue. We accordingly will not reopen the record to admit additional evidence with respect to the requirements of sec. 6013(e)(1)(C).

9. As to petitioner's allegation that respondent's counsel violated (Cont'd)

Appendix C

Our first consideration is whether, for taxable years 1980 and 1981, petitioner has established the requirements of section 6013(e)(1)(C) that, in signing each of the returns for those years, "she did not know, and had no reason to know," that a substantial understatement of tax exists as to each such return. Respondent contends that petitioner has failed to establish, inter alia, that she did not know and had no reason to know of the substantial understatements in issue when she signed the returns for the taxable years in issue, and that petitioner therefore is not entitled to relief as an innocent spouse. We agree.

The Court of Appeals for the Second Circuit, the court to which an appeal in the instant case would lie, interprets subsection 6013(e)(1)(C) as requiring a taxpayer to establish that " 'she [or he] did not know and did not have reason to know that the deduction would give rise to a substantial understatement.' " *Hayman v. Commissioner*, 992 F.2d 1256, 1261 (2d Cir. 1993), (quoting *Price v. Commissioner*, 887 F.2d 959, 963 (9th Cir. 1989), revg. an Oral Opinion of this Court), affg. T.C. Memo. 1992-228.

In the instant case, respondent contends that petitioner knew that the deductions in issue would give rise to substantial understatements when she signed the returns for the taxable years in issue. Respondent relies primarily on the testimony of

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Rule 201 and rule 3.3(a)(3) of the Model Rules, the misconduct asserted by petitioner relates only to evidence potentially pertinent to the "grossly erroneous items" issue. Because we hold that petitioner is otherwise not entitled to relief under sec. 6013(e), and, because of such holding, do not reconsider our prior holding with respect to the "grossly erroneous items" issue, we need not, and we do not, address that allegation in disposing of the instant motion.

Robert Kraft to support such contention. During the trial of the instant case, Mr. Kraft testified that he had received a law degree from Georgetown University Law Center. At a subsequent hearing, Mr. Kraft admitted that he has never received a law degree. In light of Mr. Kraft's admission, we regard his testimony as inherently untrustworthy and, therefore, do not accept his testimony. Respondent also argues that, because petitioner was a stockbroker who had passed the "series seven" stockbroker examination prior to the time she signed the returns in issue, she must have been exposed to the mechanics of commodities straddle transactions. Respondent, therefore, contends that petitioner knew that the deductions claimed on the returns for the taxable years in issue would give rise to substantial understatements. Nothing in the record, however, establishes that petitioner's studies or her work as a stockbroker exposed her to the intricacies of commodities straddle transactions.[10] Accordingly, we find that petitioner, when she signed the returns for the taxable years in issue, did not have actual knowledge that the deductions would give rise to the substantial understatements.

Even if a taxpayer does not have actual knowledge that deductions claimed on a return would give rise to a substantial understatement, a taxpayer who has reason to know of such an understatement is not entitled to innocent spouse relief. Sec. 6013(e)(1)(C). At the trial of the instant case, petitioner admitted

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10. At trial, respondent offered the testimony of several witnesses in an attempt to establish that the brokerage firm at which petitioner was employed during 1980 and 1981 routinely taught its stockbroker trainees about commodities straddle transactions. The testimony of respondent's witnesses, however, does not establish that petitioner received detailed instruction concerning commodities straddle transactions as a part of her training.

that she signed the returns for the taxable years in issue without reviewing them. Nevertheless, she is charged with constructive knowledge of their contents. *Hayman v. Commissioner*, *supra* at 1262. Petitioner was educated and should have realized her responsibility for reviewing the returns she signed. Consequently, petitioner's failure to review returns that she signed under penalties of perjury cannot be excused. *Terzian v. Commissioner*, 72 T.C. 1364, 1170-1171 (1979).

The Court of Appeals for the Second Circuit has held that the magnitude of the deductions claimed on a return may give rise to a duty to inquire as to the propriety of the deductions. *Friedman v. Commissioner*, 53 F.3d 523, 531 (2d Cir. 1995), (citing *Hayman v. Commissioner*, *supra)*, any, in part and revg. in part and remanding T.C. Memo. 1993-549. The duty of inquiry generally arises with respect to "tax returns setting forth large deductions, such as tax shelter losses offsetting income from other sources and substantially reducing or eliminating the couple's tax liability". *Hayman v. Commissioner*, *supra* at 1262.

In the instant case, we believe that even a cursory review of the returns for the taxable years in issue would have alerted petitioner to the high probability that such returns contained substantial understatements. The 1980 return reported a gain of $408,097 on Schedule D that was offset by a loss of $407,884 reported on Schedule E, which included a loss of $508,045 from TSM Associates. That return reported adjusted gross income of only $8,055 for the taxable year 1980, and tax due of $240.[11] The 1981 return, which was filed untimely on January 31, 1983, reported a gain of $697,896 on Schedule D that was offset by a loss of $679,327 reported on Schedule E, which included a loss

11. During 1980, Mr. Crowley earned $122,683 in commissions from Sinclair Securities Company.

of $413,765 from TSM Associates and a loss of $399,489 from APEX Associates. That return reported adjusted gross income of $90,658, and tax due of $13,980.[12] Both the income and deductions with respect to Mr. Crowley's commodities straddle transactions reported on the 1980 and 1981 returns were larger than the other income and deductions reported by Mr. Crowley and petitioner. Under such circumstances, petitioner had a duty to look into the propriety of the deductions taken on the returns in issue, a duty she has failed to satisfy in the instant case.[13] *Id.* Petitioner cannot obtain the benefits of section 6013(e) by simply turning a blind eye to facts that would reasonably put her on notice that further inquiry would need to be made *Bokum v. Commissioner,* 94 T.C. 126, 148 (1990), affd. 992 F.2d 1132 (11th Cir. 1993). As we have precariously noted, section 6013(e) is designed to protect the innocent, not the intentionally ignorant. *Shannon v. Commissioner*, T.C. Memo. 1991-207.

In deciding whether petitioner "had reason to know" of the substantial understatements when she signed the returns, we also take into account the factors that the Court of Appeals for the Second Circuit has held are to be considered in making such a decision: (1) The spouse's level of education; (2) the spouse's involvement in the family's business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when

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12. During 1981, Mr. Crowley earned $148,141 in commissions from Sinclair Securities Company.

13. Petitioner, however, contends that the tax returns for the taxable years in issue "indicated a roll of income from prior years to future years, leading an objective observer to conclude that any disallowance would wipe out all income and deductions relating to the transactions resulting in little or no net tax effect." Such a consideration is not a substitute for the inquiry required by the information disclosed on the returns in issue.

compared with the family's past levels of income, standard of living, and spending patterns; and (4) the culpable spouse's evasiveness and deceit concerning their finances. *Friedman v. Commissioner*, *supra* at 531-532 (citing *Hayman v. Commissioner*, *supra* at 1261). The foregoing factors are considered "because, ordinarily, they predict what a prudent person would realize regardless of the other spouse's evasiveness or deceit." *Bliss v. Commissioner*, 59 F.3d 374, 379 (2d Cir. 1995), affg. T.C. Memo. 1993-390.

Applying such factors to the facts of the instant case, we conclude that petitioner had reason to know of the substantial understatements when she signed the returns for the taxable years in issue. Petitioner was a college-educated stockbroker who had passed the "series seven" examination. She was a former life insurance agent. Petitioner's involvement in the couple's business and financial affairs was also significant. Petitioner knew that Mr. Crowley was a "commodities trader". She traveled with him to several commodities seminars, where she attempted to attract clients for her husband at the hospitality suites provided by his employer after those seminars. They routinely entertained Mr. Crowley's clients at their apartment. Petitioner and Mr. Crowley lived lavishly during 1980 and 1981, the years for which petitioner seeks relief as an innocent spouse. They frequently dined at expensive restaurants during those years. During 1980, they vacationed in Canada, Vermont, and Florida. Mr. Crowley's American Express bill for that year was approximately $90,000, and a substantial portion of that amount was charged by petitioner. During 1981, petitioner and Mr. Crowley rented a two-bedroom apartment in Manhattan for approximately $1,400 or $1,500 per month and garaged Mr. Crowley's BMW automobile for approximately $250 to $300 per month. Finally, there is no evidence in the record that shows

that Mr. Crowley was evasive or deceitful about their finances or that he attempted to conceal the fact that he had engaged in commodities straddle transactions.[14] Based on the record in the instant case, we conclude that, at the time she signed the returns for the taxable years in issue, petitioner had reason to know of the substantial understatements in issue.

Petitioner contends that the Court of Appeals' decision in *Friedman v. Commissioner, supra,* "limits" *Hayman v. Commissioner, supra,* with respect to the "reason to know" requirement of subsection 6013(e)(1)(C). Petitioner interprets the Court of Appeals' decision in *Friedman v. Commissioner, supra,* to mean that the mere fact that a large deduction was claimed from an investment partnership does not cause the alleged innocent spouse to have reason to know of the substantial understatement, where the spouse relied upon representations from her husband that such deduction was proper and where

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14. The Court of Appeals for the Second Circuit recently stated:

> According to the dissent, the petitioner should be deemed innocent because she is guileless and may not have understood why * * * [her ex-husband] should have reported his full income. This misapprehends the nature of innocence in the context of this statute. Innocent people pay taxes; the obligation to pay taxes rests on liability, not guilt. An innocent spouse within the meaning of [sec. 6013(e)] is innocent vis-a-vis a guilty spouse whose income is concealed from the innocent and spent outside the family. [*Bliss v. Commissioner,* 59 F.3d 374, 380 n.3 (2d Cir. 1995), affg. T.C. Memo. 1953-390.]

As in *Bliss v. Commissioner, supra,* there is no evidence in the record that suggests that Mr. Crowley was evasive or deceitful with respect to their finances or that he attempted to conceal the fact that he had engaged in commodities straddle transactions.

the taxpayer was not very sophisticated in financial matters. According to petitioner, when she signed the tax returns for the taxable years in issue, she was young and very unsophisticated in financial matters, having just arrived from Canada.

We disagree with petitioner's interpretation of *Friedman v. Commissioner, supra*, as well as her characterization of herself as unsophisticated with respect to financial matters. In *Friedman v. Commissioner, supra*, the Court of Appeals applied the knowledge standard that it adopted in *Hayman v. Commissioner, supra*. In *Friedman v. Commissioner, supra*, however, the taxpayer was a "housewife and unemployed former secretary with a high school education possessing only a rudimentary grasp of the simplest tax principles." *Friedman v. Commissioner*, 53 F.3d at 530.[15] The Court of Appeals held that the taxpayer in *Friedman v. Commissioner, supra* at 531, satisfied her duty of inquiry when she asked her former husband about the deductions that gave rise to the understatements, and he told her that "they resulted from a tax shelter and for her not to worry." In so holding, the Court of Appeals relied on the fact that the taxpayer knew that the returns in question had been prepared by an accountant, who was also a trusted personal friend of the family, and that the tax shelter had been recommended to her former husband by a tax expert, with whose reputation she was familiar through her past employment in her husband's business.

Petitioner, unlike the taxpayer in *Friedman v. Commissioner,*

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15. The facts of the instant case are more analogous to those of *Hayman v. Commissioner*, 992 F.2d 1256, 1258 (2d Cir. 1993), affg. T.C. Memo. 1992-228, which involved a "highly-paid, college-educated vice-president and merchandising director employed by the well-known women's clothing chain, Ann Taylor". *Friedman v. Commissioner*, 53 F.3d 523, 530 (2d Cir. 1995), (citing *Hayman v. Commissioner, supra* at 1258), affg. in part and revg. in part T.C. Memo. 1993-549.

supra, was a college-educated stockbroker when she signed the returns in issue, who admits that she failed to review those returns prior to signing them. Petitioner's failure to review the returns before signing them was apparently deliberate because nothing in the record indicates that she could not have reviewed them had she wished to do so. Petitioner claims that she signed the returns because she trusted Mr. Crowley. That trust alone, however, does not eliminate a spouse's duty to inquire when a perusal of the return would indicate that further inquiry is necessary. *Hayman v. Commissioner*, *supra* at 1262; *Stevens v. Commissioner*, 872 F.2d 1499, 1507 (11th Cir. 1989), affg. T.C. Memo. 1988-63. Consequently, we hold that petitioner has failed to prove that she did not know and had no reason to know that the deductions claimed on the returns for the taxable years in issue would give rise to substantial understatements.[16]

Turning to petitioner's contention that she is eligible for relief as an innocent spouse under the transitional rule,[17] we

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16. Our holding renders it unnecessary to consider whether petitioner has satisfied the remaining contested requirement of sec. 6013(e).

17. In *Park v. Commissioner*, 25 F.3d 1289, 1300 (5th Cir. 1994), affg. T.C. Memo. 1993-252, the Court of Appeals for the Fifth Circuit addressed the scope of the transitional rule as follows:

> a reading of the transitional rule in conjunction with section 6013(e) reveals that Congress did intend for the transitional rule to provide broader innocent spouse relief under limited circumstances to a certain class of spouses — i.e., those who filed joint returns with substantial understatements prior to January 1, 1985, and whose marriages had since terminated. See *Thompson*, 63 T.C.M. (CCH) at 2884. For such spouses,

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note that petitioner could have raised the issue of her eligibility for relief under that provision in the prior proceedings in the instant case. We also note that TAMRA, which included the transitional rule, was enacted November 10, 1988, 102 Stat. 3812, well before the instant case was tried. As noted above, it is the policy of this Court to try all of the issues raised in a case in one proceeding in order to avoid piecemeal and protracted litigation. *Alexander v. Commissioner*, 95 T.C. at 469. In the interest of judicial efficiency, we generally will not grant a motion for reconsideration to resolve issues that could have been raised during prior proceedings. *CWT Farms, Inc. v. Commissioner*, 79 T.C. 1054, 1057 (1982); *Robin Haft Trust v. Commissioner*, 62 T.C. 145, 147 (1974), affd. on this issue, 510 F.2d 43, 45 n.1 (1st Cir. 1975).

We note that the transitional rule does provide, in pertinent part, the following:

> "(D) without regard to any determination before October 21, 1988, the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such an understatement

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Congress eliminated the requirement under section 6013(e)(1)(D), which required a spouse to show that it would be inequitable to hold her liable for the understatement. In its place Congress instituted a "net worth" test, relieving the spouse from liability if she met the "no reason to know" requirement and had a net worth of less than $10,000 immediately after the termination of the marriage. Thus, under the transitional rule, unlike under section 6013(e), Congress afforded innocent spouse relief to a spouse who had benefitted from an erroneous deduction as long as after the termination of the marriage her net worth was less than $10,000.

Appendix C

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> *notwithstanding any law or rule of law* (*including res judicata*), the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such understatement, * * *. [TAMRA sec. 6004, 102 Stat. 3685; emphasis added.]

The Court of Appeals for the Fifth Circuit has found that the purpose of the foregoing language is to enable a taxpayer, who meets the requirements of the transitional rule, to be relieved of liability for an understatement as an innocent spouse notwithstanding a decision as to the taxpayer's liability prior to the enactment of the transitional rule. *Park v. Commissioner*, 25 F.3d 1289, 1300 (5th Cir. 1994), affg. T.C. Memo. 1993-252. Similarly, another court has concluded that the foregoing provisions were intended to make the relief afforded by the transitional rule "available to a person who did not have its benefit when her case was determined". *In re Freytag*, 173 Bankr. 330, 334 (N.D. Tex. 1994). We, however, do not need to decide whether the foregoing language of the transitional rule requires us to resolve the question whether petitioner qualifies for relief as an innocent spouse under the transitional rule where it was first raised in a motion for reconsideration and could have been raised in prior proceedings. Even were we to consider petitioner's claim for relief under the provisions of the transitional rule, we would nevertheless conclude that she does not satisfy its requirements.

As with the requirements for relief under section 6013(e), a taxpayer must establish that all of the conditions imposed by the transitional rule are satisfied in order to be eligible for relief

under that rule. *Park v. Commissioner, supra* at 1300. We have held above that petitioner did not satisfy the knowledge requirement of section 6013(e)(1)(C), in that she did not establish that, in signing the returns in issue, she "did not know, and had no reason to know" of the understatements in issue. Recently, in *Park v. Commissioner, supra* at 1300, the Court of Appeals for the Fifth Circuit concluded that

> The "did not know, and had no reason to know" language of the transitional rule virtually mirrors that of section 6013(e), suggesting that Congress intended the "no reason to know" requirement of both provisions to have the same meaning.

Consequently, in order to obtain relief under the transitional rule, petitioner must, under subparagraph (D) of that rule, make the same showing that she is required to make under section 6013(e)(l)(C). Petitioner has failed show that she satisfies the test of subsection 6013(e)(1)(C) and therefore would also fail to establish that she satisfies the test of subparagraph (D) of the transitional rule. Accordingly, petitioner could not find relief as an innocent spouse under the provisions of the transitional rule.

To reflect the foregoing,[18]

Appropriate orders will be issued.

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18. Although we sympathize with petitioner's plight, we are guided by the statement we made in *Sonnenborn v. Commissioner,* 57 T.C. 373, 380-381 (1971):

> The filing of a joint return is a highly valuable privilege to husband and wife since the resulting tax liability is generally substantially less than the combined taxes that would be due

(Cont'd)

Appendix C

(Cont'd)

> from both spouses if they had filed separate returns. This circumstance gives particular emphasis to the statutory rule that liability with respect to tax is joint and several, regardless of the source of the income or of the fact that one spouse may be far less informed about the contents of the return than the other, for both spouses ordinarily benefit from the reduction in tax that ensues by reason of the joint return. However, some highly inequitable results were called to the attention of Congress, particularly where a wife had been divorced or separated or abandoned after the tax year, where she was saddled with a disproportionately high tax liability as a consequence of having filed a joint return, where such liability grew out of income attributable only to the husband, unknown to the wife, and where she had not enjoyed any benefit therefrom. It was in an effort to eliminate the unfairness of the joint and several liability provisions in such circumstances that section 6013(e) was enacted. To be sure, section 6013(e) is not limited to precisely such narrow situations. But it must be kept in mind that Congress still regards joint and several liability as an important adjunct to the privilege of filing joint returns, and that if there is to be any relaxation of that rule the taxpayer must comply with the carefully detailed conditions set forth in section 6013(e). [Fn. ref. omitted]

In the instant case, we are, of course, bound to apply the law that Congress enacted. If the result we reach seems harsh, the remedy must lie with Congress, which is the body that has the power to relax the requirements for obtaining relief as an innocent spouse.

APPENDIX D — MEMORANDUM FINDINGS OF FACT AND OPINION OF THE UNITED STATES TAX COURT FILED NOVEMBER 1, 1993

[¶93,503] TC Memo 1993-503. JOHN P. CROWLEY AND ELIZABETH R. COCKRELL. Docket Nos. 28826-84, 7746-87. 11-01-93. Opinion by Wells, *J.* Years 1980-1981. Decision for Commissioner.

1. Joint returns. Taxpayer could file joint return with her husband because she was U.S. resident during taxable year, and was jointly liable for deficiency because she didn't qualify as innocent spouse. Taxpayer wasn't nonresident alien: she resided and was employed in U.S. during tax year; applied for permanent residency and received green card; and only had indefinite intention to return to Canada. Further, taxpayer wasn't entitled to innocent spouse relief because she failed to prove that reductions taken for losses incurred in commodities straddle transactions were attributable to "grossly erroneous items." Former husband's testimony that disallowed reductions involved tax-shelter transactions didn't establish that deductions had no basis in fact or law; and, fact that IRS agreed to compromise settlement, with higher interest rate applying to part of deficiencies, didn't show that claimed deductions were grossly erroneous items. *Reference:* United States Tax Reporter ¶60,135.05(7); 60,135.01(35). IRC §6013.

Official Report

Stanley Klein and Michael J. Weitzner, for petitioner John P. Crowley at docket No. 28826-84.

Gerald N. Daffner, for petitioner Elizabeth R. Cockrell at docket Nos. 28826-84 and 7746-87.

Roland Barral and William L. Blagg, for respondent.

Appendix D

MEMORANDUM FINDINGS OF FACT AND OPINION

WELLS, *Judge:* In docket No. 28826-84 respondent determined deficiencies in and additions to petitioners' Federal income taxes as follows:

Against petitioner John P. Crowley:

Year	Deficiency
1976	$ 52,437
1977	11,913
1978	31,302

Against petitioners:

Year	Deficiency
1979	$ 104,908
1980	337,115

In Docket No. 7746-87, respondent determined deficiencies in and additions to petitioners' Federal income taxes as follows:

Year	Deficiency
1981	$543,191

*50 Percent of the interest due on $543,191.

	Additions to Tax	
Sec. 6651(a)	Sec. 6653(a)(1)	Sec. 6653(a)(2)
$137,443	$27,858	*

The instant cases were consolidated for purposes of trial, briefing and opinion (hereinafter referred to as the instant case).

Appendix D

The parties have settled certain issues with respect to petitioner John P. Crowley. The parties have agreed to reduce the deficiencies to $338 for the taxable year 1977 and $6,967 for the taxable year 1978. There is no deficiency for the taxable year 1976. The parties have also settled certain issues with regard to both petitioners and, subject to our decision on the issues set forth in this Opinion with respect to petitioner Elizabeth R. Cockrell, have agreed to reduce petitioners' deficiencies to $21,250 for taxable year 1979, $45,563 for taxable year 1980, and $93,810 for taxable year 1981. Petitioners have also agreed to be liable for an addition to tax under section 6651(a)(1).[1] Respondent conceded the additions to tax under section 6653(a)(1) and (2) for the taxable year 1981. The parties have stipulated that for taxable years 1978, 1979, and 1980, $3,484, $10,760, and $22,826, respectively, are substantial underpayments attributable to tax motivated transactions, for purposes of computing the interest payable with respect to such amounts, pursuant to section 6621(c).

The following issues remain for decision: (1) Whether petitioner Elizabeth R. Cockrell was a "nonresident alien," within the meaning of section 6013(a)(1) for any portion of the 1980 taxable year;[2] and (2) whether she is entitled to "innocent spouse" relief under section 6013(e) for taxable years 1980 and 1981. As petitioner John P. Crowley has settled all issues in the instant case with respect to himself, hereinafter we will refer to

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1. All section references are to the Internal Revenue Code as in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

2. Respondent conceded that petitioner was a nonresident alien during the taxable year 1979. Consequently, petitioner is not jointly liable for the deficiency for the 1979 taxable year.

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Elizabeth R. Cockrell as "petitioner" and John P. Crowley as Mr. Crowley.

FINDINGS OF FACT

When they filed petitions, petitioner and Mr. Crowley were residents of New York, New York.

On November 14, 1979, petitioner and Mr. Crowley were married. At that time, petitioner was a Canadian citizen and Mr. Crowley was a U.S. citizen. They were married in a New York civil ceremony. On November 17, 1979, petitioner and Mr. Crowley were married a second time in a Canadian church. After the wedding and before returning to New York, they traveled to St. Martin and Colorado. Petitioner did not live in the United States prior to her marriage. During August 1979, just prior to her marriage to Mr. Crowley, petitioner quit her job, gave up the lease to her apartment, and resided in Canada with her brother.

Petitioner and Mr. Crowley discussed the possibility of moving to Canada after their marriage. During the early part of 1980, Mr. Crowley had an interview with at least one potential Canadian employer and also discussed the possibility of opening a Canadian office with his own employer at that time. Petitioner and Mr. Crowley, however, did not make any definite plans to move to Canada, and Mr. Crowley remained employed in New York.

During February 1980, petitioner completed and filed an application for status as a permanent resident. On March 31, 1980, petitioner appeared before the Immigration and Naturalization Service (INS). On April 17, 1980, the INS issued

petitioner a "green card," which petitioner had sought in order to travel to Canada and return to the United States without difficulty.

During 1980, petitioner worked for a photographer in New York City for 1 week in exchange for learning about photography. For 2 weeks, she solicited, by telephone, on behalf of a messenger service located in New York City, for which she was compensated approximately $200.

During December 1980, petitioner was hired as a stockbroker trainee in New York. In order to prepare for the series seven stockbroker examination required for her employment, petitioner studied about stocks and bonds at home. Prior to passing the exam, petitioner answered the phones at work. During the early part of 1981, petitioner passed the exam and obtained her stockbroker license. Subsequently, petitioner "cold-called" potential clients to sell them stocks and bonds. Neither petitioner's studies nor her work specifically included commodities tax straddles.

During the years in issue, Mr. Crowley was a partner in TSM Associates, Sinclair Securities Company, and APEX Associates, which were partnerships that had engaged in commodities straddle transactions involving Treasury bill options. Mr. Crowley, as an employee in James Sinclair Trading Corporation, arranged commodities straddle transactions for investors seeking "tax-sheltered investments."

Petitioner was aware of Mr. Crowley's position as a "commodities trader." Petitioner accompanied Mr. Crowley at several commodities seminars during which she "milled about" at the back of the room, "drifted" in and out of the seminar

rooms, and socialized with other wives attending the seminars. Petitioner attempted to attract clients for her husband at the hospitality suites provided by Mr. Crowley's employer. Petitioner, however, did not discuss commodities straddles transactions during the seminars or in the hospitality suites.

When petitioner and Mr. Crowley were first married they rented a one-bedroom apartment in Manhattan. During 1981, they moved to a two-bedroom apartment which they rented for approximately $1,400 or $1,500 per month. Subsequently, they rented a ranch house on Long Island. Because they experienced marital difficulties, however, they returned to New York City. During 1982, petitioner and Mr. Crowley decided to separate. After their separation, petitioner moved into a small loft apartment and paid the security deposit with $2,000 which Mr. Crowley had given her. On August 18, 1983, petitioner and Mr. Crowley were divorced.

On June 15, 1980, petitioner and Mr. Crowley signed a joint tax return for taxable year 1979, which was filed on June 24, 1980, and reported a negative adjusted gross income in the amount of $71,312. On June 15, 1981, petitioner and Mr. Crowley signed a joint return for taxable year 1980, which was filed before the end of the month and reported an adjusted gross income of $8,055. On January 26, 1983, petitioner and Mr. Crowley signed a joint return for taxable year 1981, which was filed on January 31, 1983, and reported an adjusted gross income of $90,658. The losses disallowed in the notices of deficiency were claimed by petitioner and Mr. Crowley on their 1979, 1980, and 1981 returns as Mr. Crowley's share of the losses incurred by TSM Associates, Sinclair Securities Company, and APEX Associates. During the years 1979, 1980, and 1981, Mr. Crowley earned more than $380,000.

Appendix D

Petitioner and Mr. Crowley entered a settlement agreement with respondent which provides that petitioner and Mr. Crowley may deduct 20 percent of the losses attributable to the commodities straddle transactions for the years in issue. The settlement contains the standard settlement terms offered by respondent to all taxpayers involved in the Arbitrage Management tax shelter litigation project.

OPINION

The first issue we must decide is whether petitioner was a "nonresident alien" within the meaning of section 6013(a)(1) for any portion of the 1980 taxable year. Section 6013(a)(1) provides that a joint return shall not be made "if either the husband or wife at any time during the taxable year is a nonresident alien." Section 6013, however, does not define the term "nonresident alien." Section 1.871-2(a), Income Tax Regs., states: "The term 'nonresident alien individual' means an individual whose residence is not within the United States and who is not a citizen of the United States." For the years in issue, section 1.871-2(b), Income Tax Regs., provides:

> An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intentions as to his stay, he is a resident.

The regulations also provide that an alien by reason of his

or her status as an alien is presumed to be a nonresident, but such presumption may be rebutted by "acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident." Sec. 1.871-4, Income Tax Regs.

The effect of the presumption is to relieve petitioner from having to establish at the outset that she is a nonresident alien. The burden of proof, however, remains on petitioner. Park v. Commissioner, 79 T.C. 252, 288 n.13 (1982), affd. without opinion 755 F.2d 181 (D.C. Cir. 1985); Lemery v. Commissioner, 54 T.C. 480, 486 (1970); Adams v. Commissioner 46 T.C. 352, 361 n.8 (1966). Consequently, respondent must come forth with evidence that petitioner is a resident in order to rebut such presumption.

Residency is a question of fact which must be resolved by considering all the relevant facts and circumstances. Park v. Commissioner, supra at 286; Adams v. Commissioner, supra at 358; Jellinek v. Commissioner, 36 T.C. 826, 834 (1961). The term "residency" does not have the same meaning as "domicile", but to be a resident requires the taxpayer to have some "degree of permanent attachment for the country of which he is an alien." Jellinek v. Commissioner, supra at 834.

In the instant case, the record establishes that petitioner resided in the United States during 1980. The record also establishes that, although petitioner and Mr. Crowley had discussed the possibility of returning to Canada, such discussion was nothing more than a "floating intention, indefinite as to time," which is insufficient to treat petitioner as a transient nonresident. Sec. 1.871-2(b), Income Tax Regs. We base our

conclusion upon the fact that petitioner resided in the United States during the entire year and was employed in New York City. Moreover, she applied for status as a permanent resident and was issued a green card during early 1980. In our view, such evidence rebuts the presumption of nonresidency. Furthermore, nothing in the record persuades us that petitioner had anything other than a floating, indefinite intention to return to Canada. Consequently, we hold that petitioner was a resident of the United States during 1980 and was entitled to file a joint return with Mr. Crowley. Accordingly, petitioner is jointly liable for the deficiency for taxable year 1980, unless she qualifies as an innocent spouse.

We must next decide whether petitioner qualifies as an innocent spouse under section 6013(e) for taxable years 1980 and 1981. To qualify for innocent spouse status, the spouse seeking relief must satisfy all of the requirements of section 6013(e), which provides relief only when: (1) A joint return has been made for the taxable year; (2) a substantial understatement of tax attributable to grossly erroneous items of one spouse is found on such return; (3) the other spouse establishes that he or she did not know, and had no reason to know, of the existence of such substantial understatement; and (4) it is inequitable to hold such spouse liable for the deficiency in tax attributable to such substantial understatement. Petitioner has the burden of proving each requirement of section 6013(e). Rule 142(a); Russo v. Commissioner, 98 T.C. 28, 31-32 (1992). Failure to prove any one of the requirements will preclude the spouse from relief. Purcell v. Commissioner, 826 F.2d 470, 473 [60 AFTR2d 87-5516] (6th Cir. 1987), affg. 86 T.C. 228 (1986); Bokum v. Commissioner, 94 T.C. 126, 138 (1990), affd. 992 F.2d 1132 [72 AFTR2d 93-5111] (11th Cir. 1993); Estate of Krock v. Commissioner, 93 T.C. 672, 677 (1989).

Appendix D

In the instant case, respondent concedes that a joint return was filed by petitioner in each of the years in issue and that a substantial understatement of tax exists within the meaning of section 6013(e)(3) and (4). Respondent, however, contends that such understatement was not attributable to a "grossly erroneous item." Section 6013(e)(2) defines a grossly erroneous item as:

> (A) any item of gross income attributable to such spouse which is omitted from gross income, and
>
> (B) any claim of a deduction, credit or basis by such spouse in an amount for which there is no basis in fact or law.

The phrase "no basis in fact or law," is not defined in section 6013. The courts, however, have held that a deduction has no basis in fact when the expense for which the deduction is claimed was never in fact made and a deduction has no basis in law when the expense, even if made, does not qualify as a deductible expense under well settled legal principles or when no substantial legal argument can be made to support its deductibility. Ness v. Commissioner, 954 F.2d 1495, 1498 [69 AFTR2d 92-537] (9th Cir. 1992), revg. 94 T.C. 784 (1990); Douglas v. Commissioner, 86 T.C. 758, 762-763 (1986).

To prove that the disallowed deductions have no basis in fact or law, an individual seeking innocent spouse status is not entitled to rely on the Commissioner's disallowance of deductions contained in the notice of deficiency, without introducing further evidence to establish that a deduction has no basis in fact or law. Douglas v. Commissioner, supra at 763; Rampulla v. Commissioner, T.C. Memo. 1993-504 [1993 RIA TC Memo ¶93,504]; Feldman v. Commissioner, T.C. Memo. 1993-17 [1993 RIA TC Memo ¶93,017]; Anthony v.

Commissioner, T.C. Memo. 1992-133 [1992 RIA TC Memo ¶92,133]; Cohen v. Commissioner, T.C. Memo. 1991-413 [1991 TC Memo ¶91,413], Neary v. Commissioner, T.C. Memo. 1985-261 [¶85,261 PH Memo TC].

Petitioner has not offered any evidence that would support a finding that the losses claimed on the 1980 and 1981 returns have no basis in fact or law. The losses claimed on the returns arise out of certain straddle transactions of partnerships in which Mr. Crowley invested. To be entitled to deduct such losses Mr. Crowley would have been required to show that the partnerships engaged in the commodities straddle transactions primarily for the purpose of profit. Fox v. Commissioner, 82 T.C. 1001, 1021 (1984). In Fox v. Commissioner, supra, we held that the issue of whether the taxpayer engaged in commodities straddle transactions for the primary purpose of profit is a question of fact which involves an examination of all the circumstances surrounding the transactions in issue.[3] Id. at 1022.

3. In 1984 Congress granted amnesty for pre-1981 straddle transactions. Sec. 108(a) of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630 as amended by sec. 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817-2818 (hereinafter referred to as amended sec. 108). In order to qualify for relief under amended sec. 108 of the Deficit Reduction Act of 1984 a loss on a disposition of a position is deductible if the position (1) is part of a straddle, (2) was entered into before 1982, (3) is not subject to the rules enacted in 1981, and (4) is a "transaction entered into for profit though not connected with a trade or business." In Boswell v. Commissioner, 91 T.C. 151 (1988), we held that under amended sec. 108, losses relating to commodities straddle transactions entered into before June 23, 1981, are deductible if the taxpayer's primary motive for engaging in the transactions was to realize an economic profit. In the instant case, because petitioner has failed to provide us with any information concerning the underlying transactions, we are unable to ascertain whether Mr. Crowley and petitioner would be entitled to relief under amended sec. 108 of the Deficit Reduction Act of 1984.

Appendix D

In the instant case, the only information in the record concerning the underlying transactions is the testimony of James Sinclair that TSM Associates "was a partnership engaged in speculative trading for the purposes of profit" and the testimony of Mr. Crowley that the disallowed deductions involved tax-sheltered transactions. Clearly, such testimony does not establish any basis for finding that the deductions are without any basis in fact or law.

Petitioner contends that the fact that the parties entered into a compromise settlement is proof that the deductions in question are grossly erroneous items. Under the terms of the stipulated settlement, petitioner and Mr. Crowley were allowed to deduct 20 percent of the losses attributable to the commodities straddle transactions for the years in issue. The stipulations of settled issues filed in the instant case do not disclose the basis for the allowance of 20 percent of the deductions claimed by petitioner and Mr. Crowley. Consequently, we do not think that such compromise shows that the deductions in question were grossly erroneous items. To the contrary, the fact that respondent agreed to a compromise settlement suggests that the deductions in question were less than grossly erroneous. Anthony v. Commissioner, T.C. Memo. 1992-133 [1992 RIA TC Memo ¶92,133]; Neary v. Commissioner, T.C. Memo. 1985-261 [¶85,261 PH Memo TC]. Similarly, the parties' stipulation that an increased rate of interest under section 6621(c) applies to a portion of the deficiencies does not indicate that the claimed deductions are grossly erroneous items. Id.

In short, petitioner has failed to prove that the deductions taken for losses incurred in the commodities straddle transactions have no basis in fact or law. Consequently, we hold that they are not attributable to "grossly erroneous items" within the meaning

of section 6013(e)(2). Accordingly, we hold that petitioner is not entitled to innocent spouse relief under section 6013(e) for the taxable years in issue.

To reflect the foregoing,

Decisions will be entered under Rule 155.

FILED
JAN 28 1998
CLERK

No. 97-877

In the Supreme Court of the United States

OCTOBER TERM, 1997

ELIZABETH R. COCKRELL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a taxpayer is entitled to "innocent spouse" relief from joint and several income tax liability under Section 6013(e) of the Internal Revenue Code, 26 U.S.C. 6013(e), when she signed joint federal income tax returns without reading them or enquiring as to the substantial "commodity straddle loss" deductions claimed on them.

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-4a) is unreported. The opinion of the Tax Court (Pet. App. 28a-40a) is reported at T.C. Memo. 1993-503, 66 T.C.M. (CCH) 1180. The supplemental opinion of the Tax Court (Pet. App. 7a-27a) is reported at T.C. Memo. 1995-551, 70 T.C.M. (CCH) 1374.

JURISDICTION

The judgment of the court of appeals was entered on June 24, 1997. On September 2, 1997, Justice Ginsburg extended the time to file a petition for a writ of certiorari to and including November 21, 1997. The petition for a writ of certiorari was filed on

November 21, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a college-educated Canadian citizen and former life insurance agent. In 1979, she married a United States citizen named John Crowley (Pet. App. 4a, 10a-11a, 20a, 23a, 31a). Crowley was a partner in several partnerships that engaged in commodity straddle transactions involving Treasury bill options (*id.* at 11a, 32a). Petitioner was aware that Crowley was a commodities trader (*id.* at 12a, 20a, 32a). She accompanied him to commodities seminars and tried to help him attract clients to his business (*id.* at 4a, 12a, 20a, 32a-33a). Petitioner testified, however, that she did not understand the nature of the business and never discussed commodities straddle transactions with Crowley (*id.* at 12a; C.A. App. 221-222, 262-263). In December 1980, petitioner was hired as a stockbroker trainee. In early 1981, she obtained her broker's license (Pet. App. 4a, 11a, 20a, 23a, 32a).

Petitioner and Crowley filed joint federal income tax returns for 1980 and 1981 on which they claimed sizable deductions for losses resulting from Crowley's commodity straddle transactions (Pet. App. 3a, 12a-13a, 18a-19a, 33a). Petitioner stated that she signed both returns without first reviewing them (*id.* at 3a, 13a, 17a-18a, 23a). She further testified that she had not discussed the returns either with Crowley or with Robert K. Kraft, a tax advisor who worked for petitioner's employer and who assisted Crowley with the 1981 return (*id.* at 3a, 19a; C.A. App. 100, 223, 224-228).

By August 1983, petitioner and Crowley were divorced (Pet. App. 12a, 33a). The Commissioner of Internal Revenue determined deficiencies in the 1979, 1980 and 1981 income tax returns of petitioner and Crowley. The deficiencies resulted primarily from disallowance of the deductions claimed for the losses from commodity straddle transactions (*id.* at 13a, 29a, 33a).

2. Petitioner and Crowley sought review of the asserted deficiencies in Tax Court. They settled the underlying deficiencies pursuant to the terms offered to all taxpayers who had been engaged in similar straddle transactions (Pet. App. 13a-14a, 30a, 34a). The settlement, however, left open the issue whether petitioner was entitled to "innocent spouse" relief for 1980 and 1981 (*id.* at 30a).

Spouses who file joint federal income tax returns are normally jointly and severally liable for the full amount of tax due on their combined incomes. 26 U.S.C. 6013(d)(3). If a spouse can satisfy the requirements of 26 U.S.C. 6013(e), however, she can be relieved of liability for tax deficiencies due to the erroneous tax items of the other spouse. A spouse is entitled to "innocent spouse" status if she can demonstrate (i) that a joint return was filed for the year at issue; (ii) that the return contained a substantial understatement of tax due to the grossly erroneous items of the other spouse; (iii) that in signing the return she did not know or have reason to know of the understatement; and (iv) that it would be inequitable to hold her liable for the understatement. 26 U.S.C. 6013(e). A taxpayer must satisfy *all* of these requirements to be entitled to innocent spouse status.

The Tax Court rejected petitioner's contention that she was entitled to innocent spouse relief (Pet. App. 39a-40a). The Tax Court noted that a taxpayer seeking innocent spouse status must introduce evidence—beyond the mere disallowance of the deduction—to establish that the deduction is "grossly erroneous" (26 U.S.C. 6013(e)). The court found that petitioner had not offered such evidence in this case (Pet. App. 37a-39a). Because petitioner had failed to satisfy that component of the test for innocent spouse status, the Tax Court did not address the other statutory prerequisites for such relief (*id.* at 8a n.4, 36a-40a).

On petitioner's motion for reconsideration, the Tax Court issued a supplemental opinion in which it found, as an additional ground to deny innocent spouse relief, that petitioner had "reason to know" of the substantial understatements (Pet. App. 7a-27a).[1] The court emphasized that petitioner should have realized that she was responsible for reviewing the returns before signing them (*id.* at 17a-18a, 22a-23a): she was well educated; she was involved in her husband's financial affairs; she enjoyed a comfortable standard of living; and she had produced no evidence that Crowley was evasive or deceitful about the family finances or that he concealed information from her (*id.* at 18a-23a). The Tax Court found that (i) the deductions on the returns were of sufficient magnitude to give rise to a duty to enquire as to their

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[1] Petitioner errs in stating that the Tax Court withdrew its first ruling (Pet. 8 n.5, 24). In issuing its second opinion, the Tax Court stated that, given the state of the record, it "need not reconsider the holding of our prior Opinion" (Pet. App. 7a n.*, 14a-15a).

propriety and (ii) petitioner had failed to fulfill that duty (*id.* at 18a-19a). The Tax Court concluded that innocent spouse status is unavailable in this case because 26 U.S.C. 6013(e) "is designed to protect the innocent, not the intentionally ignorant" (*id.* at 19a).

3. The court of appeals affirmed in a brief, unpublished order (Pet. App. 1a-4a). The court concluded that the deductions on the returns were so substantial that a duty to enquire as to their validity necessarily arose (*id.* at 3a). "Yet, despite this indication that the tax returns might contain substantial understatements, [petitioner] took no steps to fulfill even the most minimal duty to enquire as to the propriety of the tax shelter deductions. She failed to ask her husband or anyone else about the legality of the deductions they claimed." (*Ibid.*) (internal quotation marks omitted). The court of appeals noted that petitioner was educated, that she was (at least in a limited way) involved with Crowley's business, that the couple lived "lavishly," and that there was no evidence that Crowley was evasive or deceitful about the couple's finances or about the commodity straddle deductions (*id.* at 4a). The court concluded that there were ample grounds for the Tax Court to find that petitioner had "reason to know" that the deductions would give rise to substantial understatements and that she was therefore not entitled to innocent spouse relief (*ibid.*).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Husbands and wives can generally lower their federal income tax liability by filing a joint income tax return rather than separate returns. For such filers, the progressivity of the tax rates is eased by doubling (compared to spouses filing separate returns) the amount of income subject to tax in each bracket. See 26 U.S.C. 1. The price exacted for that privilege is that spouses who file joint returns normally are jointly and severally liable for the full amount of tax due on their combined incomes. 26 U.S.C. 6013(d)(3). Joint and several liability may be avoided under the "innocent spouse" provision only if the spouse demonstrates, among other requirements, that she neither knew nor had reason to know that the return contained a substantial understatement of tax attributable to the grossly erroneous items of the other spouse. 26 U.S.C. 6013(e)(1)(B) and (C).

Although, as a remedial statute, 26 U.S.C. 6013(e) is applied liberally in favor of the person claiming its benefits (*Friedman* v. *Commissioner*, 53 F.3d 523, 528-529 (2d Cir. 1995)), it is also true that Congress provided only a narrowly defined "innocent spouse" exception from joint liability. *Park* v. *Commissioner*, 25 F.3d 1289, 1293 (5th Cir.), cert. denied 513 U.S. 1061 (1994). As the Tax Court correctly explained, joint and several liability is "an important adjunct to the privilege of filing joint returns, and . . . if there is to be any relaxation of that rule [of joint liability] the taxpayer must comply with the carefully detailed conditions set forth in section 6013(e)" (Pet. App. 27a n.18, quoting *Sonnenborn* v. *Commissioner*, 57 T.C. 373, 381 (1971)).

2. Petitioner errs in asserting (Pet. 10-16) that the decision in this case conflicts with decisions of other circuits. Innocent spouse cases are inherently fact-

specific (*Hayman* v. *Commissioner*, 992 F.2d 1256, 1260 (2d Cir. 1993); *Guth* v. *Commissioner*, 897 F.2d 441, 443 (9th Cir. 1990)), and an examination of the cases relied on by petitioner demonstrates that the courts have applied the same legal analysis to the unique facts of each case.

a. In cases involving erroneous deductions, the Second Circuit has adopted the analysis set forth by the Ninth Circuit in *Price* v. *Commissioner*, 887 F.2d 959 (1989). See *Friedman* v. *Commissioner*, 53 F.3d at 530-532; *Hayman* v. *Commissioner*, 992 F.2d at 1261. The court in *Price* stated that a duty of enquiry arises when the taxpayer who seeks innocent spouse relief "knows sufficient facts such that a reasonable prudent taxpayer in her position would be led to question the legitimacy of the deduction." 887 F.2d at 965. A failure to fulfill that duty therefore "may result in constructive knowledge of the understatement being imputed to her." *Ibid.* See also *Reser* v. *Commissioner*, 112 F.3d 1258, 1267-1268 (5th Cir. 1997); *Resser* v. *Commissioner*, 74 F.3d 1528, 1535-1543 (7th Cir. 1996); *Kistner* v. *Commissioner*, 18 F.3d 1521, 1525 (11th Cir. 1994); *Erdahl* v. *Commissioner*, 930 F.2d 585, 589-591 (8th Cir. 1991); *Guth* v. *Commissioner*, 897 F.2d at 443-445; *Stevens* v. *Commissioner*, 872 F.2d 1499, 1505, 1507 (11th Cir. 1989). The presence on a return of deductions that are large in comparison to a couple's income may place a spouse on notice that further enquiry is warranted. *Reser* v. *Commissioner*, 112 F.3d at 1267-1268; *Friedman* v. *Commissioner*, 53 F.3d at 531; *Hayman* v. *Commissioner*, 992 F.2d at 1262; *Price* v. *Commissioner*, 887 F.2d at 965-966; *Stevens* v. *Commissioner*, 872 F.2d at 1507. Courts have also agreed that, in assessing the claimed "innocent

spouse" defense of a taxpayer, a court should consider her education, her involvement in family financial affairs, the presence of expenditures that are lavish or unusual compared to the family's prior financial status, and the other spouse's evasiveness or deceit in family financial matters.[2] *Price* v. *Commissioner*, 887 F.2d at 965. See *Reser* v. *Commissioner*, 112 F.3d at 1267; *Resser* v. *Commissioner*, 74 F.3d at 1536; *Kistner* v. *Commissioner*, 18 F.3d at 1525; *Erdahl* v. *Commissioner*, 930 F.2d at 590-591; *Guth* v. *Commissioner*, 897 F.2d at 444; *Stevens* v. *Commissioner*, 872 F.2d at 1505.

The differing results reached in innocent spouse cases turn on the particular facts of each case, not on differing interpretations of the applicable law. In some of the cases cited by petitioner, the courts concluded that the wife fulfilled her duty to enquire. Compare *Resser* v. *Commissioner*, 74 F.3d at 1541-1543 (wife questioned transactions and was assured by husband of their legitimacy; no duty to "re-enquire" at time of signing return); *Price* v. *Commissioner*, 887 F.2d at 966 (wife questioned husband and received reassurances prior to signing return), with *Stevens* v. *Commissioner*, 872 F.2d at 1507 (wife had doubts regarding return but blindly signed anyway; innocent spouse status denied). In others, it was determined that the wife lacked a meaningful reason or opportunity to enquire. *Kistner* v. *Commissioner*, 18 F.3d at 1526-1527 (husband denied wife access to financial records and threatened violence if she questioned returns); *Pietromonaco* v. *Commissioner*,

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[2] Contrary to petitioner's suggestion (Pet. 12 n.6), in *Hayman* v. *Commissioner*, 992 F.2d at 1261, the Second Circuit merely followed *Price*. It did not formulate a new test.

3 F.3d 1342, 1344-1347 (9th Cir. 1993) (omitted income case, husband was evasive and controlled business affairs, lifestyle and spending patterns were insufficient to place wife on notice of omitted income from husband's business); *Guth* v. *Commissioner*, 897 F.2d at 444-445 (husband hid information; wife was insufficiently aware of unusual nature of transactions to trigger duty of inquiry).

In the present case, petitioner is a college-educated stockbroker and former life insurance agent who testified that she did not review her joint returns prior to signing them (Pet. App. 3a-4a, 11a, 13a, 17a-18a, 20a, 23a). Those returns contained sizable deductions for commodity straddle losses ($407,884 in 1980 and $679,327 in 1981) (*id.* at 3a, 12a-13a, 18a-19a, 33a). Petitioner testified that she never discussed the commodities straddles with Crowley and did not discuss the returns with either Crowley or Kraft, who worked at her office (*id.* at 3a, 12a, 19a; C.A. App. 100, 221-223, 224-228, 262-263). There was no evidence that Crowley was evasive or deceitful regarding the couple's finances (Pet. App. 4a, 20a-21a, 23a). The Tax Court correctly held that petitioner is not entitled to innocent spouse status simply because she remained willfully ignorant of substantial deductions on the couple's joint returns (*id.* at 3a-4a, 17a-19a, 22a-23a, 26a). Other courts have similarly concluded that innocent spouse status is not appropriate in such circumstances. See, *e.g.*, *Friedman* v. *Commissioner*, 53 F.3d at 525; *Erdahl* v. *Commissioner*, 930 F.2d at 589; *Price* v. *Commissioner*, 887 F.2d at 965-966. See also *Stevens* v. *Commissioner*, 872 F.2d at 1507.

b. Petitioner errs in asserting (Pet. 10-12) that the decision in this case conflicts with the decision of the

Fifth Circuit in *Reser* v. *Commissioner*, 112 F.3d at 1269. Mrs. Reser was a personal injury attorney married to the sole shareholder of a corporation that had elected to be taxed under subchapter S of the Internal Revenue Code. That corporation had losses of $257,354. *Id.* at 1260-1261. The income of subchapter S corporations is normally passed through and taxed directly at the shareholder level; losses of such corporations, however, are passed through and deductible by shareholders only to the extent of their basis in the corporation. *Id.* at 1263-1264. When she signed the 1987 joint return, Mrs. Reser thought that she and her husband had invested sufficient funds in the S corporation to cover the losses from the corporation that they deducted on their return for that year. *Id.* at 1268. As it turned out, however, the Resers had an insufficient basis in the corporation to allow them to use the loss deductions, and a large joint income tax deficiency therefore resulted. *Id.* at 1261-1265.

On the particular facts of that case, the Fifth Circuit held that Mrs. Reser was entitled to innocent spouse status. 112 F.3d at 1272. The court explained that Mrs. Reser did not have a duty to enquire into the correctness of the basis assumption for two reasons. *Id.* at 1269. First, the court stated that her case was "not the typical 'dramatic deductions' case" because, given Mrs. Reser's knowledge of the finances of the S corporation, there was nothing surprising to her about the large loss deductions on the return. *Ibid.* Second, the court stated that Mrs. Reser had no duty to make further enquiries because "any further inquiry would have been informatively futile under the discrete facts of this case." *Id.* at 1269, 1272. The court explained that the propriety of

the loss deductions turned on a "hypertechnical determination" regarding whether Mr. Reser or the corporation had borrowed certain funds and that the professionals involved in preparing the joint return had a genuine (if incorrect) belief that the loss deductions were correct. *Id.* at 1269.

The "discrete facts" on which the court relied in *Reser* plainly make that decision distinguishable from the present case. While Mrs. Reser was found to have a reasonable expectation that the joint return would contain large deductions, petitioner had no similar basis for any such assumption (Pet. App. 3a, 12a-13a, 19a; C.A. App. 100, 221-223, 224-228, 262-263). Indeed, if, as petitioner asserts, she was uninformed as to the details of her husband's business, the large deductions on the returns should have put her on notice that something highly unusual must have occurred with respect to their financial situation. That sort of unusual financial development is precisely the sort of fact that, under the consistent holdings of the courts of appeals, triggers a duty of further enquiry on her part. See page 7, *supra*.[3]

The distinction between these decisions thus rests upon the differences in their underlying facts. These factual differences in the application of the applicable legal test for "innocent spouse" relief do not warrant

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[3] Further, in *Reser* there was "no doubt" that, if Mrs. Reser had asked further questions, she would have been informed by the professionals who prepared her return that the deductions were correct. 112 F.3d at 1269. Petitioner, by contrast, has offered only the supposition that Crowley would have informed her that the commodity straddle deductions were legitimate (Pet. 11-12, 17). In the Tax Court, however, she failed to adduce any evidence on that issue. (See Pet. App. 4a, 20a-21a.)

review by this Court. The decision in the present case would, in any event, be an unsuitable vehicle for review of the asserted conflict, for the denial of the "innocent spouse" defense in this case rests upon the additional ground that the commodity straddle loss deductions were not "grossly erroneous," as the statute requires. See page 4, *supra*.[4]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JANUARY 1998

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[4] Moreover, as petitioner notes (Pet. 19-22), legislation is pending in Congress that could alter the scope of the "innocent spouse" statute. The issue that petitioner seeks to frame for review therefore has only an uncertain prospective importance.

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No. 97-877

In The

Supreme Court of the United States

October Term, 1997

ELIZABETH R. COCKRELL,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR PETITIONER

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QUESTION PRESENTED

The issue to be decided is whether and in what circumstances a fair reading of Section 6013(e)(1)(C) of the Internal Revenue Code imposes an implied duty of inquiry for a non-culpable person to qualify as an innocent spouse; and, if under any circumstances the duty is imposed, whether such duty exists under circumstances where such inquiry would be unreasonable or futile.

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on June 24, 1997. On September 2, 1997, Justice Ginsburg extended the time to file a petition for a writ of certiorari to and including November 21, 1997. The petition for a writ of certiorari was filed on November 21, 1997. Respondent's request for an extension of time to file a reply brief was granted by the Clerk of this Court on December 24, 1997 extending the time to file a response to and including January 28, 1998. On January 28, 1998, a Brief for the Respondent in Opposition ("Resp. Br.") was filed and an amicus brief was filed by Richard C.E. Beck, Esq., National Taxpayer's Union, Women's Bar Association of the State of New York and The National Organization for Women Foundation. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

This reply fully concurs with the points addressed in the Amicus Brief. This reply will specifically and exclusively address the portions of Respondent's Brief which are inaccurate or misleading. Each such inaccurate or misleading statement will be addressed in the order found in Respondent's Brief.

ARGUMENT

Respondent is incorrect in asserting that since each case contains different facts, there is no conflict in the circuits. In particular, Respondent incorrectly asserts that the decision in *Reser v. Commissioner*, 112 F.3d 1258 (5th Cir. 1997) does not conflict with the case at bar. (Resp. Br. at 9-12). In *Reser*, an attorney at law claimed innocent spouse relief from a large deduction of $257,354. There, despite her advanced education, the Fifth Circuit ruled that the taxpayer was an innocent spouse even though she did not inquire concerning the propriety of the deduction. The court reasoned that such inquiry would have been futile and

therefore held that "[n]either the court nor the law will penalize Reser for failing to perform the hollow act of asking questions, the answers to which would have provided no new or different information."

These facts are indistinguishable from those in the case at bar (except to the extent that Petitioner only held a bachelor's degree in English while Ms. Reser was a licensed attorney). In the facts of this case, since her husband himself was a promoter of the tax shelter, certainly a request of him as to the propriety of the deductions stemming therefrom would not have yielded any new or different information.

Next, Respondent argues that the existence of large deductions on the returns should have alerted Petitioner that "something highly unusual must have occurred with respect to their financial situation." (Resp. Br. at 11). Even if that were true, as noted in *Reser*, the duty of inquiry is obviated if such inquiry would prove futile. The existence of a tax shelter on a return in 1980 or 1981 was far from unusual. As pointed out in *Friedman v. Commissioner*, 53 F.3d 523, 531 (2d Cir. 1995):

> In the early 1980s it was a matter of common knowledge that wily investors could find legal ways and means of attaining spectacular tax benefits through cunning investment strategies. See, e.g. Deborah Rankin, *Personal Finance: The Continued Appeal of Tax Shelters*, N.Y. Times, Aug. 8, 1982, § 3 at 13 . . . Mere knowledge that the spouse has invested in a tax shelter resulting in substantial tax savings is accordingly, without more, insufficient to establish constructive knowledge of a substantial understatement. (Internal citations omitted).

Respondent also points to Petitioner's college degree as evidence that she was educated and therefore held to a higher standard. (Resp. Br. at 2, 9). This argument was squarely rejected

in *Resser v. Commissioner*, 74 F.3d 1528, 1537 (7th Cir. 1996) which held that "petitioner's liberal arts degrees did not enable her to be familiar with the business and financial concepts needed to question financial decisions." (Citing *Robertson v. Commissioner*, 63 T.C.M. (CCH) 1822, 1826, 1992 WL 3724 (1992)). *Resser*, 74 F.3d at 1537, therefore held that

> [t]he record will not support a determination that a reasonably prudent taxpayer with Mrs. Resser's education could be expected to know that the losses claimed in the 1982 tax return, based on highly complex financial transactions, contained a substantial understatement.

Respondent ignores the case of *Guth v. Commissioner*, 897 F.2d 441 (9th Cir. 1990) which held that no duty was triggered even where an innocent spouse

> was aware of the bare existence of the transactions leading to the deductions [and] was apparently not aware of anything unusual about them. It is this subjective awareness on the part of the taxpayer of something odd or unusual about the circumstances leading to the understatement that triggers the duty to inquire.

Respondent also ignores *Resser* which held that a duty of inquiry is only triggered under a subjective test of whether "a reasonably prudent taxpayer in her position [would] be led to question the legitimacy of the deduction." *Resser*, 74 F.3d at 1541; *Erdahl v. Commissioner*, 930 F.2d 585, 591 (8th Cir. 1991); *Guth v. Commissioner*, 897 F.2d 441 445 (9th Cir. 1990). The court in *Resser* concluded that the wife did not have a duty to inquire even though she did not read the return before signing it.

Respondent argues, in a footnote, that since legislation is pending in Congress that could alter the scope of "innocent spouse"

status, this case's prospective importance is uncertain. (Resp. Br. 12 at n.4) As pointed out in Petitioner's Petition for Certiorari, the current proposal passed by the U.S. House of Representatives and being considered by the U.S. Senate does not affect the prospective effect of a decision by this Court. The issues to be decided — the meaning of the "did not know and had no reason to know" language contained in § 6013(e)(1)(C) and whether such language imposes a duty of inquiry and in what circumstances — will not be effected by the legislation since no change to § 6013(e)(1)(C) is contemplated by H.R. 2292 (Internal Revenue Service Restructuring and Reform Act of 1997).

Finally, it is not at all surprising that Respondent fails to mention the horrific Internal Revenue Service abuses inflicted against Petitioner. Respondent clearly hopes to pretend the abuses did not occur while attempting to hold Petitioner to an exceedingly high standard found in some cases such as *Kistner* and *Stevens* while downplaying the more taxpayer-friendly legal principles found in cases such as *Reser*, *Guth* and *Resser*. This Court should not countenance such unfair tactics.

CONCLUSION

For the reasons set forth in this reply brief and in the Petition for Certiorari, the Petition for Certiorari should be granted.

Respectfully submitted,

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF AMICUS CURIAE OF RICHARD BECK, THE NATIONAL TAXPAYERS UNION, WOMEN'S BAR ASSOCIATION OF THE STATE OF NEW YORK AND NATIONAL ORGANIZATION FOR WOMEN FOUNDATION IN SUPPORT OF PETITIONER

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PERMISSION TO FILE BRIEF AS AMICI CURIAE

Richard Beck, The National Taxpayers Union, the Women's Bar Association of the State of New York and The National Organization for Women Foundation file this brief as *amici curiae* in support of Petitioner, pursuant to Sup. Ct. Rule 37.2. A letter of Respondent, dated January 21, 1998, and a letter of Petitioner, dated January 21, 1998, by which counsel for the parties evidenced their consent to the filing of this brief have been filed with this Court.

INTERESTS OF AMICI CURIAE

Richard Beck is a law professor who has written extensively on innocent spouse issues. He is taking no fee and has no financial interest in this case.[1]

The National Taxpayers Union is a non-profit public interest organization devoted to the advancement of justice for taxpayers.

The Women's Bar Association of the State of New York ("WBASNY") is the largest bar association in the United States specifically devoted to the advancement of the rights of women. WBASNY and its fifteen chapters, representing localities throughout the State of New York, are committed to promoting fairness and equality in the study, practice and application of the law. WBASNY is a progressive force, actively involved in molding public policy and advancing legal reform. WBASNY is dedicated to the professional and personal advancement of women and the pursuit of justice in our judicial system and society at large.

The National Organization for Women Foundation is a 501(c)(3) organization devoted to furthering women's rights through education and litigation. NOW Foundation is affiliated with the National Organization for Women, the largest feminist organization in the United States, with a membership of over 200,000 women and men in more than 500 chapters in all 50 states and the District of Columbia. Since its inception in 1986, a major goal of NOW Foundation has been to ensure equal opportunities and fair treatment for women, including particularly the rights of women during marriage and after divorce.

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[1] Pursuant to Rule 37.6, of the rules of this Court: Richard Beck is the sole author of this brief, and he worked *pro bono*. Printing costs were paid by Petitioner.

SUMMARY OF THE ARGUMENT

The United States is virtually the only country in the world which forces separated and divorced women to pay their ex-husbands' taxes. Joint return liability was not and cannot be justified by the alleged benefits of joint filing, nor by any other coherent principle. An estimated ninety per cent of the victims of joint liability are women[2] despite the fact that the benefits of joint filing, if any, are largely enjoyed by their husbands. The IRS routinely pursues women, as in Petitioner's case, even when they cannot pay, and without any attempt to find or tax the husband who is responsible for the deficiency.

The problem is an urgent one. By the government's own estimate as many as 75,000 women per year are unfairly forced to pay their ex-husbands' taxes every year for no reason except that they signed joint returns.

As a relief measure, the innocent spouse rules should be liberally construed in favor of taxpayers. And because the underlying liability is itself ill-founded and unfair, liberal construction of the relief rules is *a fortiori* necessary.

Congress never intended to impose any "duty of inquiry" into the accuracy of the husband's tax items on a joint return as if the wife were an auditor, and it is unreasonable for the courts to invent and impose any such duty on their own. The "knowledge" test of Section 6013(e)(1)(C) must in any event be tempered by a rule of reason or proportionality to prevent minor failures of proof from being punished with catastrophically unfair consequences. We think Congress intended the wife to prevail if "under all the facts and circumstances it would be inequitable" to deny her relief, even in cases where the wife may have had

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[2] For that reason we refer hereinafter to the non-earning spouse who is pursed under joint return liability as the "wife." Although the rule of joint return liability is gender-neutral as drafted in Section 6013(d)(3), its effects are dramatically injurious to women.

some difficulty meeting her high burden of proof under Section 6013(e)(1)(C).

Finally we think it *per se* inequitable for the IRS to pursue the wife before attempting to collect from the husband who caused the deficiency. In cases where the size of the assessment is likely to cause great hardship, as in Petitioner's case, it is a shocking abuse of power.

The split in the circuits caused by the Second Circuit's decision affords the Court a timely opportunity to interpret the innocent spouse rules so as to stop the IRS from persecuting tens of thousands of women every year. The Court has never decided an innocent spouse case before, and it is time to do so now.

I. NATURE AND HISTORY OF JOINT AND SEVERAL LIABILITY.

A. JOINT AND SEVERAL LIABILITY IS AN UNFAIR BURDEN UPON WOMEN WHICH IS UNIQUE TO THE UNITED STATES.

Approximately 95% of married taxpayers file jointly each year because filing separately usually results in a higher tax. Very few taxpayers are aware, or have any reason to be aware, that by doing so they incur joint and several liability. There is no joint liability clause at all on the Form 1040 itself, not even in fine print, much less the salient warning that such a risk deserves. Nor does it appear that tax preparers or divorce lawyers generally take this liability into account.

A 1997 General Accounting Office("GAO") Report estimates that there are about 80,000 instances per year of potential collections through Section 6013(d), that is to say collections

from the wrong spouse, *after divorce*.[3] The GAO Report found that few taxpayers apply for innocent spouse relief, in part because there are no IRS forms or procedures to apply, and that the relatively few claims which are made are mostly denied at the administrative level for purported failure to prove "no reason to know" of the husband's understatement under Section 6013(e)(1)(C). Most petitioners also lose in Tax Court because of the same "reason to know" test which is at issue here.

There are now over 600 reported court decisions involving spouses attempting to resist joint liability through the "innocent spouse" rules which were enacted in 1971, and in the last few years the Tax Court alone has averaged over 50 decisions per year.

Over 90% of the victims of joint liability collections are women. According to the GAO Report, the IRS usually attempts collection from whichever spouse it finds first. This has a significantly negative effect upon women, because after divorce the wife often remains at the marital address on the joint return, and the IRS will often look no further, even if the victim tells the IRS where to find her ex-husband. Petitioner's case is all too typical: the IRS clearly knows Mr. Crowley's whereabouts, and has apparently done nothing to collect from him.

No other developed country in the world imposes joint and several liability for income taxes, including countries which also offer income-splitting on joint returns.[4] In countries which once imposed such liability, it has been repealed as unfair and

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[3] GAO Report B-271456, "Information on the Joint and Several Liability Standard," March 12, 1997.

[4] France is a partial exception, but its spousal collection powers are used far more sparingly. See Beck, Richard, "The Innocent Spouse Problem: Joint and Several Liability Should be Repealed," 43 Vand. L. Rev. 317, 382-89 (1990).

inconsistent with modern women's rights to economic independence.

In fact joint and several liability was completely unjustified when first enacted in the U.S. in 1938. An unforeseen explosion in divorce rates, combined with extreme aggressiveness on the part of the IRS, have created a major national problem.

In 1995, after many years' study of the problem, the American Bar Association recommended to Congress that it repeal joint liability (1995-2 ABA Reports 8E) because it is unfair and unjustified. In 1996, Congress began holding hearings on the desirability of repeal, and commissioned two studies of the feasibility of repeal, one the GAO Report cited above, and the other, as yet unfinished, from the IRS.

B. JOINT RETURN LIABILITY WAS NOT AND CANNOT BE JUSTIFIED BY THE ALLEGED BENEFITS OF JOINT FILING, NOR BY ANY OTHER COHERENT PRINCIPLE.

The rule of joint return liability was first enacted in 1938 to overrule the Ninth Circuit's decision in *Cole v. Commissioner*, 81 F.2d 485 (9th Cir. 1935). In *Cole* a large tax deficiency due entirely to the wife's substantial separate income could not be collected from her because the Bureau of Internal Revenue had assessed her husband instead, and negligently allowed the statute of limitations to run as to the wife. When it discovered its error, the Bureau then continued trying to collect from the husband, on the wholly invented theory that filing jointly entails joint and several liability. The government argued in *Cole* that "administrative necessity" required joint and several liability because joint returns do not explicitly set forth the respective separate incomes and deductions of the spouses,[5] and that

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[5] The argument seems not to have been made in good faith, however, because at that very same time, the Treasury was promulgating regulations

without joint liability it would be unable to determine the amount each spouse should pay.[6] The Ninth Circuit rejected this argument because the separate liabilities of the spouses were in fact stipulated in *Cole*, and then noted that if a case should arise in which some doubt actually existed, the Bureau remained free to assess both spouses and let them prove their respective incomes. The court then offered a farsighted conclusion that Congress would have done well to heed:

> One of the fundamental principles of taxation is that the incidence of a tax should be in accordance with the ability to pay. In income taxation, this means that the tax should be levied in proportion to income. That is all which the petitioner herein asks. If this cardinal principle is followed, justice will be done.

After its loss in *Cole*, the Bureau urged Congress to enact joint and several liability, which Congress did in 1938. The only explanation put forth in the committee reports was the same "administrative necessity" which had been rejected in *Cole*. Thus Congress' intention seems to have been to prevent a perceived unjust enrichment of still-married couples in cases

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which would limit charitable deductions on joint returns to 15% of the donor spouse's *separate* net income, which necessarily involved the very same calculations of separate incomes which the government argued it was powerless to make in *Cole*. For details, see Beck, *id.* at pp. 343-47. It is also noteworthy that in the approximately 600 reported innocent spouse cases, determining whether an erroneous item is attributable to the husband under Section 6013(e)(1)(B) is virtually never an issue despite the fact that a purported "difficulty" in determining which items are whose on a joint return was the only reason ever offered by the government for imposing joint return liability.

[6] The Bureau apparently did not consider the obvious expedient of rewriting its joint return forms for taxpayers to disclose two columns of income and expense, one for each spouse.

where the Bureau negligently failed to assess the correct spouse, as in *Cole*.

Joint and several liability was far too broad a solution to the perceived problem, if indeed there ever was a problem at all. A much better and more focused solution, for example, might have been to authorize an extended statute of limitations applicable to a taxpayer if he has notice of an incorrect assessment against his spouse.

At any rate, Congress improvidently handed the Bureau a blank check which it gradually emboldened itself to employ - and abuse - in situations very far removed from its original purpose. The current application of section 6013(d) to separated and divorced women seems entirely unintended. None of the half dozen cases decided before 1938, including *Cole*, involved divorce, nor could the postwar explosion in divorce rates have been foreseen in 1938.

Pursuing divorced women for their husbands' taxes without even attempting to collect from the husband is simply an abuse of power.

Ironically, Section 6013(d) collections now *create* unjust enrichments between ex-spouses, whereas the provision was originally enacted to *prevent* unjust enrichments in cases of intact marriages.

Adequate reasons for imposing joint and several liability have never been provided. Contrary to widely held belief, joint return liability was not enacted as the "price one must pay" for lower tax rates on joint returns.[7]

Joint returns were first introduced in 1918, apparently for the sole purpose of convenience both for taxpayers and for the government, and provided no special rates or privileges for married persons. The favorable tax rates for joint returns computed by income-splitting were not introduced until 1948,

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[7] The error is widely repeated, even in court decisions, see e.g. *Stevens v. Comm'r* 872 F.2d 1499 (11th Cir. 1989).

some 10 years after enactment of joint liability. Income-splitting was not enacted as a reward for assuming joint return liability, but for the entirely different purpose of equalizing the tax burden between the common law states and the community property states, where income-splitting was already allowed on separate returns under the doctrine of *Poe v. Seaborn*, 282 U.S. 101 (1930).

The quid-pro-quo justification for joint return liability is as weak logically as it is historically. The tax advantage of joint filing is quite modest (except in rare cases). But even this "advantage" exists only when compared with the punitive rates applicable to married persons filing separately. For nearly half of all couples, joint returns require higher taxes (the "marriage penalty") than the couple would pay if they were not married at all.[8]

Moreover, the size of the alleged benefits of joint filing bears no relation to the joint return liability assumed, which may be unlimited in amount. The benefit explanation cannot justify joint liability for an amount greater than the tax saving from filing jointly.

Finally, the "benefits" usually inure to the husband, while the liability almost always is borne by the wife. Joint return liability is not only unfair in principle, it is highly discriminatory against women as applied.

A second rationalization for joint liability is that the married couple is an economic unit, and as it shares its income and assets it should share its tax burden.[9] However, there is no evidence that couples who file jointly share assets any more than

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[8] According to the Congressional Budget Office, for the year 1996, 42% of married couples owed an average of $ 1,400 more in taxes than if they had been single, and 51 % received an average "marriage bonus" of $ 1,300.

[9] The GAO Report repeats this as well as the income-splitting canard at p. 2.

those who file separately.[10] In any case, it is ludicrous to apply the one-pocketbook theory of marriage to couples who have already divorced and divided their assets.

II. THE INNOCENT SPOUSE RULES

In 1971, Congress enacted the innocent spouse rules codified at Section 6013(e) in response to some astonishingly harsh decisions of the Tax Court. In *Scudder v. Commissioner*, 405 F.2d 222 (6th Cir. 1968), *rev'g* 48 T.C. 36 (1967) the Tax Court held the wife liable for huge amounts of tax on her husband's embezzlements which he had concealed from her and spent on other women, and where the business from which he embezzled was owned by the wife and her sisters! The Sixth Circuit reversed *Scudder* and several other Tax Court decisions on the ingenious theory that if the wife did not know of or profit from the embezzlements, her signature to the joint return was void as to such items because it was procured by the husband's fraud.

The statutory relief rules were narrowly drafted to do little more than codify the Sixth Circuit's *ad hoc* approach in *Scudder*. Congress gave little, if any, thought to other situations in which relief should be granted, nor did it reexamine the appropriateness of joint liability itself. As a result, the innocent spouse rules are oddly restrictive, and in many respects illogical. For example, relief is generally not available if the husband simply fails to pay his taxes, or makes an honest mistake as to the law. He must have done something *wrong* which he concealed from his wife.

The innocent spouse rules exempt a spouse from joint return liability under Section 6013(e)(1) if she establishes that (A) a joint return has been filed; (B) the return contained a substantial understatement of tax attributable to grossly erroneous items of her husband; (C) in signing the return, she did not know, and

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[10] Beck at 377-82.

had no reason to know of the understatement; and (D) taking into account all the facts and circumstances, it is inequitable to hold her liable for the deficiency attributable to the understatement. The burden of proof as to all items is on the petitioner for relief, and she must prove each element.

A. A WIFE IS NOT AN AUDITOR, AND HAS NO DUTY TO INQUIRE

The most difficult test for the wife is that she must prove that at the time of signing the return, she did not know, and had no reason to know, that there was an understatement. This "innocence" test, which is at the heart of the relief rules, is illogical and inappropriate as a basis for relief. Ordinarily, a reason to know (or due diligence) test is applied in the context of assessing whether a person who is in a position to prevent foreseeable harm to others has breached a duty of care. In this tax context, however, the duty of care arises from the relief rules themselves, rather than from any preexisting and independently justifiable duty.

If the wife does not sign the return, the government is not helped in any way, because the husband can simply file his own erroneous return. The IRS cannot plausibly claim that it relies on the wife's signature to certify the accuracy of the husband's income, as if she were an auditor. It cannot help knowing what everyone else knows, that women do not feel they have any such duty, and do not act as if they did. The government does nothing to make women aware of their liability. Just the opposite. The Form 1040 contains no assumption of liability clause, not even in fine print. If the government actually wanted women to know of and act upon their supposed duty of care, it would put a prominent warning at the signature line. Instead, by concealing the wife's liability, the government deliberately sets a deadly trap.

Even if a wife is aware of her supposed "duty" of inquiry, the penalty for its breach is inappropriate and unfair. If a professional return preparer or an IRS agent fails to use due diligence, he does not become liable for the tax deficiency he could reasonably have been expected to discover on someone else's return. And yet the IRS does rely upon the tax expertise and professional responsibility of such persons.

The tax term "innocent spouse" was evidently borrowed from the matrimonial law of the 1960s where rights to divorce or alimony depended upon marital "fault" or "innocence" in matters such as adultery. This importation into tax terminology was unfortunate and misleading because the wife who fails the knowledge or equity tests of Sections 6013(e)(1)(C) or (D) is no more "guilty" of any "fault" than one who fails the dollar limitations of Section 6013(e)(3). A wife who becomes aware of her husband's tax cheating has done nothing wrong herself. No one suggests a wife in this position should denounce her husband to the IRS; all she is expected to do is file separately. Bizarrely, it does not even count in her favor if she attempts to dissuade her husband from cheating - instead it usually counts *against* her because it proves she had the forbidden knowledge! See *Shea v. Commissioner*, 780 F.2d 561 (1985). Almost always, the wife who cannot qualify under the innocent spouse rules is guilty of only one thing: having signed a joint return.

According to numerous unfortunate decisions the wife is supposedly put on notice that something may be amiss in the husband's taxes by such factors as unusual or lavish expenditures or a reported income which is suspiciously low in relation to the couple's lifestyle, and such notice triggers a duty to inquire further. See *Sanders v. United States*, 509 F.2d 162 (5th Cir. 1975). However, this purported duty of inquiry cannot be found in the Code, or the legislative history, or even the Treasury Regulations which are altogether silent on the crucial question of interpreting Section 6013(e)(1)(C).

It is noteworthy that no reported decision suggests that a wife must go so far as to consult an outside tax expert of her own as to the law,[11] or a private detective, say, regarding possible unreported income. In short, no court asks the wife to discover the true facts or determine the precise legal character of her husband's acts. The deepest inquiry which any reported decision would impose is for her simply to ask her husband whether the tax return is correct. As Petitioner correctly points out, and as the Seventh, Eight, Ninth and Eleventh Circuits have held with respect to tax shelters, such an inquiry is pointless if she already knows that her husband will tell her that the return is correct.

We think the best explanation of what Congress meant by Section 6013(e)(1)(C) is that the wife must not have *actual knowledge* of a *non-tax* transaction, such as the embezzling in *Scudder*, which is of a kind that a reasonable person would have "reason to know" would lead to an *understatement of tax*. In the *Scudder* situation, actual knowledge of the embezzling might give rise to "reason to know" of a deficiency because embezzlers do not ordinarily report their income from embezzling.

Under this interpretation there is no duty to review the return itself, much less any duty to make inquiries on the basis of items found in the return. This explanation of Congress' intent has the merit of a direct grounding in the *Scudder* decision which was the model for the innocent spouse rules, and it imports a minimum of illogic into the statutory language. It comports also with the "grossly erroneous" test under Section 6013(e)(2) which in effect limits relief to situations in which the husband has done something wrong. In the first 1971 version of the rules, only omissions of income qualified for relief.

When Congress extended relief in 1984 to items of deduction, credit or basis, it limited relief to items having "no basis in fact or law," a phrase which has baffled the courts and

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[11] See *Friedman v. Comm'r*, 53 F. 3d 523 (2d Cir. 1995)(wife is not required to seek independent tax counsel).

commentators. Whatever the phrase may mean exactly, it clearly was intended to limit relief to cases in which the husband has done something *wrong*, as in the omission cases. Because the "reason to know" language is equally applicable to deductions, it seems reasonable to apply the same test as for omitted income. Thus to be liable, the wife must have *actual knowledge* of a transaction or facts which in and of themselves appear wrongful and which would lead a reasonable person to expect an understatement without reviewing the return and without further inquiry. Examples might include the wife's knowledge that the husband intended to claim losses which are identical to those which she knew had already been proven phoney in a prior year, or knowledge that he intended to deduct gambling losses and to prove them by other people's losing tickets which she observed him picking up at the track.

B. THE EQUITY TEST IS A RULE OF REASON OR OVERALL FAIRNESS, AND THE IRS VIOLATES IT WHENEVER IT DOES NOT ATTEMPT COLLECTION FROM THE HUSBAND FIRST.

Under the equity test, the wife must prove that under all the facts and circumstances, it would be inequitable to hold her liable. The principal question is whether the wife benefitted from the understatement over and above ordinary support. Other factors which have occasionally been taken into account are whether the wife has been deserted or divorced,[12] and whether she was overreached or deceived, as in *Scudder.*[13]

There is ample support both in the statutory language itself and in the case law for the common-sense proposition that

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[12] Reg. 1.6013-(5)(b). See also *Mysse v. Comm'r*, 57 T.C. 680 (1972)

[13] See *Purcell v. Comm'r*, 826 F.2d 470 (6th Cir. 1987).

equity requires the size of any benefits received to be balanced against the size of the understatement, and that the wife's financial hardship should be taken into account in determining whether to impose liability. For example, in *Estate of Brown v. Commissioner*, 55 T.C.M. 1249 (1988), a wife was given relief on the explicit ground that the $500,000 deficiency was "utterly disparate" when compared to the (apparently not inconsiderable) property she had received pursuant to her divorce. Similarly in *Dakil v. Commissioner*, 496 F.2d 431 (10th Cir. 1974) the court exonerated a widow because of the size of the assessment, despite evidence she had significantly benefitted during marriage, with these words: "The unnecessarily harsh attempt to collect from her individually the tax liabilities of her husband should never have been made, and having been made, should be cast into oblivion. Even a tax collector should have some heart." See also *Terzian v. Commissioner*, 72 T.C. 1164 (1979).

The reported decisions are unanimous in reciting that the wife must prove separately that she qualifies under both the knowledge and the equity tests of Section 6013(e)(1)(C) and (D), and that failure to prove one is fatal to relief even if she proves the other. After making this ritual assertion, however, many courts then go on to ignore it in the decisions themselves for a very good reason. There are often circumstances where it would be inequitable to tax the wife even if she knew of the husband's tax malfeasance. For example, in *Hayes v. Commissioner*, 57 T.C.M. 869 (1989) the Tax Court granted relief to a deserted and impecunious wife whose husband failed to declare his wages and had denied to her that he was working. She herself verified the fact that he was working, and had good reason to suppose he was hiding his wages from the IRS as well as from herself. See also *Ratana v. Commissioner*, 662 F.2d 220 (4th Cir. 1981), where a religious and hardworking mother was exonerated despite undisputed knowledge of her husband's unreported income, and *Quint v. Commissioner*, 49 T.C.M. 1465 (1985), where the wife was exonerated although she knew of her

husband's defalcations, on the ground that she believed the funds had been repaid.

We think that Congress clearly intended the overriding criterion for relief to be equity under the circumstances. The alleged rule that the "knowledge" and "equity" tests must be applied disjunctively has no basis other than clumsy draftsmanship in the statute. It is an impermissible interpretation because it implies the absurdity that Congress expressly intended to permit inequitable decisions. If an assessment is so disproportionate as to dwarf any benefit the wife may have received and will threaten her with serious hardship, clearly the potential harm must be balanced against her knowledge under Section 6013(e)(1)(C) by weighing the nature, degree, and probability of her awareness. It is difficult to believe that Congress could have intended otherwise.

As applied to Petitioner's case, this rule of reason provides a second ground for exoneration because the assessment is completely beyond her means and will simply bankrupt her. Even if one accepted the government's view that Petitioner received some benefit or that she was not entirely unaware, which we do not, the alleged knowledge and/or benefit is so minimal that the punishment is utterly unconscionable.

The IRS often pursues the wife exclusively, even in cases where she obviously lacks the means to pay the assessment and will simply be driven into bankruptcy as a result of an IRS victory, as in Petitioner's case.

According to the GAO Report, the IRS lacks any internal records or procedures to determine whether collection would be easier from the husband. The reported decisions never explain why the husband is not pursued, although in many the husband seems solvent and available and sometimes even testifies in the litigation, as in the case at bar. See also the outrageous decision in *Cohen v. Commissioner*, 54 T.C.M. 944 (1987), where a divorced schoolteacher was held liable for her husband's tax shelter, though the husband was a CPA and a tax partner in the

firm of Peat, Marwick. In response to Ms. Cohen's question why she was being pursued rather than the husband, the court told her that the IRS can choose as it pleases, and added that she would have the right to collect from her husband afterwards in a separate lawsuit for contribution!

We think that it is *per se* inequitable for the IRS to pursue the wife without first exhausting possible collection efforts against the husband, and that the equity test of Section 6013(e)(1)(D) can and should be read to say so in all cases. At the very least this should be the rule if the assessment is so large as to cause hardship. We would define hardship in the same way as "substantial understatement" under Section 6013(e)(4), because that specifies the level at which Congress thought some escape valve to be necessary, namely, where the assessment exceeds 10% of the wife's gross income for the preceding year, or 25% if her income exceeds $ 20,000.

It is not easy to think of any reason why the IRS should be allowed to employ its Section 6013(d)(3) collection powers to create such unfair and unreasonable hardship as in Petitioner's case without first establishing at least some minimum showing of need. *Congress did not intend the IRS to use joint liability for the gratuitous and irresponsible persecution of women.*

We think the IRS might actually collect more revenue at less cost if it stopped using joint liability altogether, although the IRS own failure to keep records makes this hard to prove. Some *amici* have seen in our own work the IRS waste taxpayer money pursuing single mothers on public relief for assessments they could not possibly pay. Petitioner's case is the same writ large: if the government wins, it will succeed only in bankrupting Petitioner at enormous cost to all involved, and then if it wants actually to collect its taxes it will have to look to the ex-husband Mr. Crowley, which is where the IRS should have started and ended.

CONCLUSION

The Second Circuit's decision should be reversed on the ground that it misinterpreted the innocent spouse rules, as well as on the ground of government misconduct described in Petitioner's brief. Petitioner had no knowledge or reason to know that Mr. Crowley's tax shelter deductions were illegitimate, and no duty to make idle inquiries of him. Petitioner did not benefit from the tax savings during her brief marriage and received no alimony or property settlement afterwards. The size of the assessment pressed upon Petitioner is shocking to the conscience and violates the equity rule of Section 6013(e)(1)(D).

Respondent has violated the same rule of equity by not providing even the slightest indication why the IRS has not collected from Mr. Crowley who, as the IRS itself agrees, alone caused the deficiency. The IRS has given no reason for its relentless and shocking persecution of Petitioner by fair means and foul.

Respectfully submitted,

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